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Building the Future for Canadians

Budget 1997

Budget Plan

Tabled in the House of Commons
by the Honourable Paul Martin, P.C., M.P.
Minister of Finance

February 18, 1997



Canada



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**Including Supplementary Information and
Notices of Ways and Means Motions**

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Department of Finance
Canada

Ministère des Finances
Canada



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Introduction and Overview

Building the Future for Canadians

Canada is in the midst of an important turnaround in its public finances – one that will remove the burden of high deficits and rising debt on the country's economic potential, thus setting the stage for stronger job-creating growth. For the federal government, this turnaround was set in train by actions taken in the last three budgets. This budget continues the progress achieved to date by announcing that the deficit in 1996-97 will be no higher than \$19 billion – \$5.3 billion less than the deficit target of \$24.3 billion. It also ensures that the government remains firmly on track to meet its 1997-98 and 1998-99 targets. At the same time, it proposes key investments and targeted tax relief to encourage job creation and to invest in a stronger society.

Canada faced large fiscal, economic and social challenges when the government took office in the fall of 1993. Federal finances were deteriorating. The economy was still trying to shake off the effects of the 1990-1991 recession. While inflation had been reduced to very low levels, the expected payoff in lower interest rates could not be fully realized as long as fiscal imbalances went unchecked. High and rising debt hampered the economy's performance and threatened Canada's long-term growth potential – at a time when Canada needed to position itself as a stronger and more vital player in the global economy. The prospect of ever-increasing government debt – with more and more of each tax dollar going to debt servicing – also threatened the sustainability of valued programs that promote the health and well-being of Canadians.

The government recognized that restoring financial health would have to be a central component of any strategy for stronger job-creating growth. To ignore this imperative would have meant that the ever-increasing fiscal burden would negate any other actions taken to encourage economic growth and job creation.

The fiscal actions set in train by the government's first three budgets ensure a firm and steady decline in the deficit. Based on prudent planning assumptions and including the Contingency Reserve, the deficit will hit a 22-year low of \$9 billion in 1998-99, and financial requirements – net new borrowings in financial markets – will show a small surplus. The debt-to-GDP ratio will finally show a meaningful turnaround in 1997-98 and 1998-99, after more than two decades of virtually uninterrupted increases.

Restored fiscal health, while necessary, is not sufficient to ensure that Canada achieves its full potential. Nor can it guarantee that prosperity will benefit all Canadians.

To help secure these broader economic and social objectives, actions taken to reduce the deficit have been complemented by targeted investments to address specific structural issues and enhance fairness. The government has made, and will continue to make, such investments to further enhance both short-term and long-term job creation and growth and address priorities in health, education and other programs that contribute to the well-being of Canadians. The government has also taken, and will continue to take, selective tax actions to enhance fairness and to provide additional assistance to individuals and businesses in fulfilling their potential in the modern economy.

This strategy is working. In this budget, the government is setting out actions to build on the progress achieved to date in building for the future by:

- staying the course on restoring Canada's fiscal health;
- investing in immediate jobs and growth;
- investing in long-term job creation and growth; and
- investing in a stronger society.

This budget:

- announces that the deficit in 1996-97 will be no higher than \$19 billion, including new spending initiatives;
- contains no new expenditure cuts;
- contains no new taxes; and
- proposes targeted tax relief and strategic investments to encourage jobs and growth and to build a stronger society.

Building the Future: Staying the Course on Restoring Canada's Fiscal Health

On track for fiscal renewal

Restoring Canada's fiscal health is key to stronger growth and job creation and to protecting the future of valued programs that protect the health and well-being of Canadians.

The deficit has been reduced at a measured and orderly pace, in order to allow the economy, Canadians and the government itself time to adjust to the effects of reduced government spending. The government's fiscal strategy has been deliberate, measured and responsible, based on two-year rolling deficit targets. The deficit targets are based on prudent planning assumptions, backed by sizeable Contingency Reserves to guard against unexpected developments. The targets represent the least that will be achieved in any one year, not the best that can be achieved.

Expenditure reductions have been the overwhelming source of deficit reduction. They have been based on fundamental reform of federal government programs. An Expenditure Management System has been put in place to ensure that tight control of departmental spending will continue. Transfers to individuals have been reformed, or are in the process of being reformed, to make them more targeted and sustainable – ensuring that scarce financial resources assist the most needy in Canada. Transfers to other levels of government have been restructured to make them more predictable, affordable and flexible – to allow funds to be better directed to specific needs and priorities in the provinces. Revenue measures have been focused on enhancing the fairness of the tax system.

Deficit targets have been bettered ...

The strategy is working. The deficit outcomes for both 1994-95 and 1995-96 were below the targets (Table 1.1). The 1995-96 deficit outcome was at that time the single largest annual decline in over 40 years.

Table 1.1
Deficit targets and outcomes

	1994-95	1995-96	1996-97	1997-98	1998-99
(billions of dollars)					
Targets	39.7	32.7	24.3	17.0	9.0
Actual and expected outcomes	37.5	28.6	19.0 ¹		

¹ Estimated to be no greater than \$19 billion.

... and this progress will continue

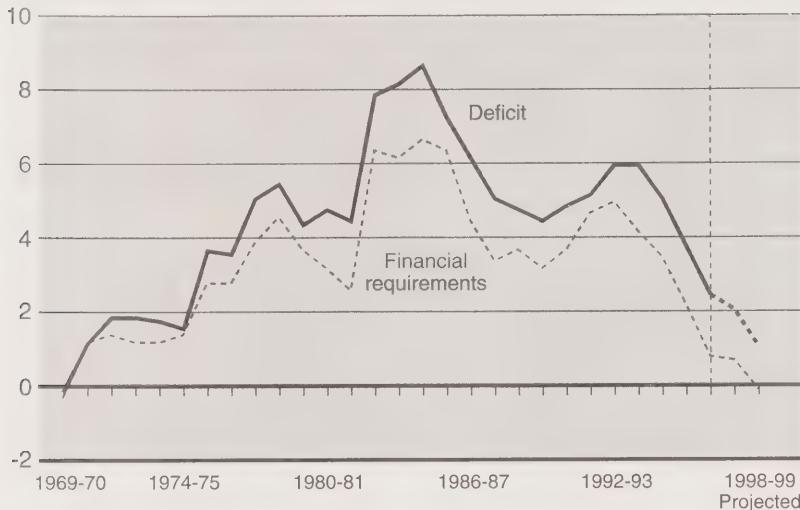
Looking forward, financial results to date indicate that the deficit for 1996-97 will come in below the target of \$24.3 billion. This will be the third consecutive year that the deficit target will have been bettered. Current fiscal data suggest that the final deficit outcome, including this year's new spending, will be no higher than \$19 billion or 2.4 per cent of gross domestic product. This will be \$5.3 billion below the target of \$24.3 billion or 3 per cent of GDP. It will also be more than \$9½ billion lower than the deficit in 1995-96 – the largest year-over-year decline ever. This outcome means that the federal deficit as a share of GDP will have declined by more than half from its level in 1993-94 (Chart 1.1).

The greater-than-expected improvement in 1996-97 reflects the payoff from lower interest rates. Public debt charges are now expected to be about \$2.3 billion lower than estimated in the 1996 budget. Strict control over program spending has also contributed to this progress; program spending is expected to be at the same level projected in last year's budget. As a consequence, the Contingency Reserve of \$2.5 billion will again not be needed.

The government is clearly on track to meet its deficit targets of \$17 billion for 1997-98 and \$9 billion for 1998-99. There are no further expenditure cuts proposed in this budget, nor are there any new taxes. Indeed, this budget proposes targeted tax relief.

Chart 1.1*Public accounts deficit and financial requirements*

per cent of GDP



The decline in the deficit since 1993-94 is overwhelmingly due to actions taken in the last three budgets to reduce program spending. Actions taken by the government since taking office will have reduced the 1998-99 deficit by \$28 billion from what it otherwise would have been. Of this, 91 per cent is due to expenditure reductions.

As a result, the level of program spending will be \$103.5 billion in 1998-99, \$16.5 billion lower than in 1993-94. This represents a decline of 13.8 per cent in five years. Over this period, the ratio of program spending-to-GDP will have fallen from 16.8 per cent to 11.9 per cent – about 5 percentage points – while the revenue-to-GDP ratio will have remained largely unchanged.

In the near future, Canada will reach two important fiscal milestones on the road to achieving a balanced budget.

- First, financial requirements will be in a small surplus position in 1998-99 (Chart 1.1). This means that the government will not have to go to private credit markets for new borrowing, other than that required to roll over the existing stock of debt. Financial requirements are comparable to the way most other major industrialized countries, including the United States, measure their deficits. In these countries, achieving zero financial requirements would mean

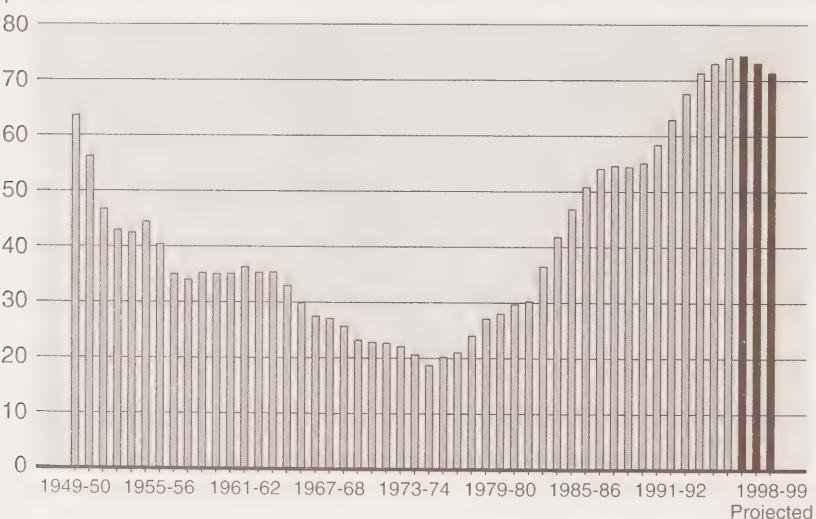
balancing their budgets. According to international projections, in 1998 Canada will be alone in the Group of Seven (G-7) large industrialized countries in being able to claim this achievement.

■ Second, growth in the debt-to-GDP ratio will slow dramatically in 1996-97 and will decline in 1997-98. This will be the first meaningful decline in this ratio since 1974-75 (Chart 1.2). More importantly, it will continue to decline in 1998-99. This improvement in the debt-to-GDP ratio is significant because it means that the burden of the debt will be falling in relation to the country's ability to pay.

Chart 1.2

Federal government net debt

per cent of GDP

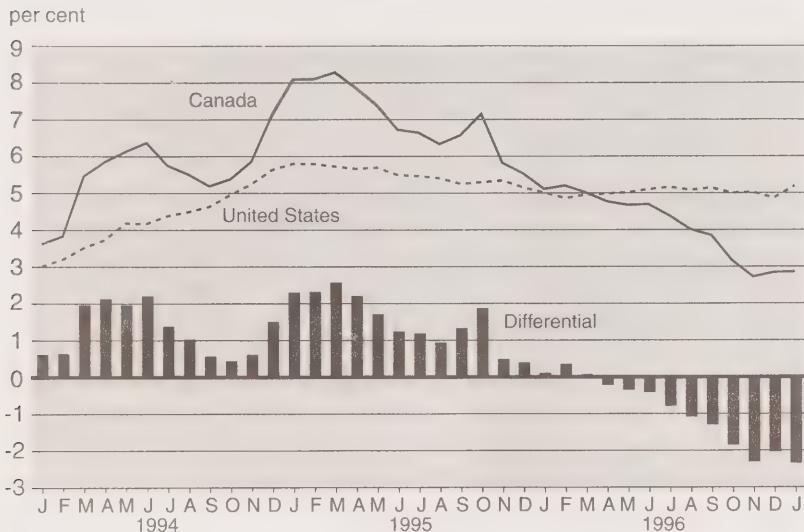


The payoff from fiscal action is emerging

Federal measures to reduce the deficit and put the debt-to-GDP ratio on a firm downward track have been complemented by actions by the provinces to put their finances in order. Different provinces have followed different strategies to achieve this goal, but the end result is that enhanced federal and provincial fiscal credibility has allowed interest rates to better reflect underlying economic fundamentals in a way that could not be achieved while fiscal imbalances persisted in the late 1980s and early 1990s.

Interest rates have declined dramatically (Chart 1.3) – both in absolute terms and vis-à-vis the U.S. – in response to continued low inflation and increased fiscal credibility among all levels of governments. These declines have benefited consumers, businesses and governments alike.

Chart 1.3
3-month Treasury bill rates



Reducing the deficit and putting the debt-to-GDP ratio on a firm downward track are not ends in themselves. Rather, they are the means to lower interest rates and restored consumer and business confidence, on the way to sustained growth in domestic demand and jobs. The lower interest rates that have resulted from increased fiscal credibility and the resulting improvements in business and consumer confidence bode well for demand and job growth. Chapter 2 describes the strong growth that international forecasters foresee over the next two years – growth strong enough to generate significant job creation. However, this encouraging outlook depends on staying the course on improving the nation's finances.

Staying the fiscal course

While significant fiscal progress has been made, the battle to restore Canada's fiscal health is not yet over: the federal deficit in 1996-97 will still be as high as \$19 billion, with a debt-to-GDP ratio at about 74½ per cent. The last time the deficit was this low was in 1981-82, but at that time the debt-to-GDP ratio was only about 30 per cent.

The ongoing fiscal policy challenges are:

- first, to ensure that the deficit targets continue to be met; and
- second, to ensure that the debt-to-GDP ratio declines to more manageable levels in a reasonable period of time.

This will require continued firm fiscal management and the careful setting of priorities.

Staying the course fiscally does not mean standing still on other priorities. In the last three years, the government has reallocated resources and carefully set priorities in order to invest in jobs and support health, education and other valued programs. These investments have been accommodated while keeping the deficit on a firm downward track. This budget continues on that course.

Building the Future: Supporting Jobs and Growth

During 1996, economic growth was below potential, job creation was disappointing and the unemployment rate remained unacceptably high. Direct government job creation clearly cannot solve Canada's unemployment problem. Government policies can, however, support job creation in the private sector by ensuring that the Canadian economy and Canadians themselves are well equipped to take full advantage of the international economy.

The government outlined its comprehensive strategy for economic growth and enhanced job creation in the fall of 1994 in the document *A New Framework for Economic Policy*. This strategy has been the foundation for the budgets and other reforms undertaken since then.

Investing in immediate jobs and growth

The economic conditions favourable to healthy private sector demand and employment growth are now in place. However, low interest rates have only recently begun to translate into stronger growth. The government will continue to invest in those areas of the economy that would provide immediate growth and job potential, thereby serving as a bridge until the full benefits of lower interest rates are realized.

To assist job creation in the short term, the government announced, in November 1996, employment insurance (EI) premium relief to small firms in 1997 and 1998 through the New Hires Program. Building on the transitional premium relief program included in EI reform, this program increases the relief from \$150 million to \$465 million over two years for firms that had paid premiums of less than \$60,000 in 1996. This program will virtually eliminate EI premiums for almost 900,000 eligible small businesses hiring new employees in 1997. At the same time, the government announced an additional five-cent reduction in the EI employee premium rate for 1997, from \$2.95 in 1996 to \$2.90 in 1997. For planning purposes, a further 10-cent reduction is assumed for 1998.

In December 1993, the government launched a \$6 billion Canada Infrastructure Works partnership between the federal government and provincial and municipal governments in response to the widespread need to upgrade and renew municipal infrastructure. Further support for employment is being provided by a \$425 million federal top-up to the program for 1997-98, announced in January 1997. This top-up will bring the federal contribution for 1997-98 to \$600 million, levering up to \$1.8 billion in new investment. The Residential Rehabilitation Assistance Program (RRAP) and related programs have also been extended at a cost of \$50 million for another year.

This budget builds on these measures by proposing additional actions to promote growth and employment in the near term including:

- adding support for tourism by providing incremental funds to the Canadian Tourism Commission and creating a new tourism financing facility to be administered by the Business Development Bank of Canada;
- increasing support for rural development by raising the funding of the Community Access Program and expanding the capital of the Farm Credit Corporation;
- strengthening assistance to small business by reducing their paper burden, expanding activity under the *Small Business Loans Act*, and encouraging labour-sponsored venture capital funds to invest in small businesses; and
- further support for export promotion through a broadening of export financing capacity in conjunction with the Export Development Corporation and the private sector.

Investing in long-term job creation and growth

The government is committed to innovative approaches to enhancing the long-term potential of the Canadian economy and ensuring that Canadians are well positioned to realize their potential in the new economy. This approach involves the leverage of scarce resources to expand the impact of government actions through increased private sector partnerships.

As in the 1996 budget, the initiatives announced in this budget focus on the strategic areas of education and research and development through:

- the provision of additional tax assistance to help students and their families better cope with the rising costs of higher education and to assist workers in enhancing their skills; and
- the establishment of the Canada Foundation for Innovation – a new Foundation to be operated independently of government through a board of directors drawn from the private sector and research and academic communities – whose purpose will be to lever private sector funding to enhance education and research infrastructure at post-secondary institutions and research hospitals.

Building the Future: Investing in a Stronger Society

The government has always argued that good economic policy is good social policy. At the same time, a strong economy must be built on a strong society. The 1996 budget announced a number of reforms to secure the future of health, education and other valued programs. These included stable and more predictable funding for federal transfers to provinces for health, post-secondary education and welfare, additional assistance for health research, proposed changes to the retirement income system and enhanced support for families and charities.

This budget furthers the government's agenda to build a stronger society by:

- addressing a number of the recommendations of the National Forum on Health;
- providing additional support to children in low-income families;
- improving support for people with disabilities; and
- taking further steps to encourage charitable giving.

This budget takes immediate steps to strengthen Canada's health care system, following up on a number of recommendations made by the National Forum on Health:

- a Health Transition Fund is being established to assist provinces and territories in developing projects to test ways to improve Canada's health care system;
- a new Canada Health Information System will be put in place to give health care providers access to the best medical information; and
- additional funding is being provided to the Community Action Program for Children to help children at risk, and the Canada Prenatal Nutrition Program to help mothers at risk have healthier babies.

A key concern for Canadians is the needs of children in low-income families. Some programs intended to help these children create disincentives for their parents to work and trap families on welfare. The federal government shares with provincial and territorial governments the objective of moving toward a more effective and integrated system of child benefits that will:

- provide improved children's services and income support for low-income families while protecting the income of families on social assistance; and
- reduce the financial disincentives for parents to make the transition from welfare to the workforce.

The 1996 budget took the first steps in this direction by doubling the funding for the Working Income Supplement (WIS) to help increase the financial independence of families. This budget goes further with a substantial enrichment of the Child Tax Benefit as a basis for eventual joint federal-provincial-territorial action to better integrate the system of child benefits and to assist children in low-income families.

This budget also proposes actions to provide increased assistance over and above initiatives announced last year to help those with disabilities and to enhance charitable donations:

- assistance is being provided through an Opportunities Fund and additional tax and tariff relief to help the disabled overcome difficulties in participating more fully in the Canadian economy; and
- further tax changes will create additional incentives for donations in support of charitable activities.

Summary of Fiscal Actions

The net fiscal impact of initiative announced since the 1996 budget, including measures announced in this budget, amount to \$765 million in 1996-97, \$991 million in 1997-98, \$730 million in 1998-99 and \$917 million in 1999-2000 (Table 1.2).

These initiatives will be accommodated within a profile for program spending for each year of this budget's planning horizon that is either the same or below the level foreseen in last year's budget. It will also mean that through the savings put in train in its four budgets, the government will have secured over \$28 billion in net fiscal savings in 1998-99. The lower annual deficits that will have resulted from these actions will mean nearly an \$89 billion dollar reduction in net debt from what it otherwise would have been in 1998-99.

Table 1.2*Summary: fiscal impact of policy initiatives since the 1996 budget*

	1996-97	1997-98	1998-99	1999-2000
(millions of dollars)				
Gross fiscal impact of initiatives				
Investing in jobs and growth				
Measures announced prior to 1997 budget		735	75	10
Immediate jobs and growth		213	65	67
Long-term job creation and growth:				
Higher education and skills		47	137	202
Research and innovation	800		31	32
Investing in a stronger society				
Sustaining and improving Canada's health care system		83	108	108
Towards a National Child Benefit System		50 ¹	470 ¹	600
Helping Canadians with disabilities		40	90	100
Support for charitable giving		30	100	100
Total	800	1198	1076	1219
Reallocations/other reallocations		-82	-201	-202
Extension of temporary tax on banks		-25	-45	
Tobacco excise tax increase Nov. 96	-35	-100	-100	-100
Total	-35	-207	-346	-302
Net fiscal impact of initiatives	765	991	730	917

(+) sign indicates an increase in the deficit and net debt.

(-) sign indicates a decrease in the deficit and net debt.

¹ assumes a July 1, 1998 start-up. If implemented earlier, total would be larger by up to \$150 million.

Summary of Fiscal Results to 1998-99

Table 1.3 shows the major fiscal results to 1998-99, including actions from this budget. Including the initiatives announced in this budget, the deficit for 1996-97 will be about \$5½ billion below its target, while the government is clearly on track to meet its deficit targets for 1997-98 and 1998-99.

Table 1.3
*Summary statement of transactions:
 fiscal outlook with budget measures¹*

	1994-95	1995-96	1996-97	1997-98	1998-99
(billions of dollars)					
Budgetary revenues	123.3	130.3	135.5	137.8	144.0
Program spending	118.7	112.0	109.0	105.8	103.5
Operating balance	4.6	18.3	26.5	32.0	40.5
Public debt charges	42.0	46.9	45.5	46.0	46.5
Underlying deficit	-37.5	-28.6	-19.0	-14.0	-6.0
Contingency Reserve				3.0	3.0
Deficit	-37.5	-28.6	-19.0	-17.0	-9.0
Net public debt	545.7	574.3	593.3	610.3	619.3
Non-budgetary transactions	11.6	11.4	13.0	11.0	10.0
Financial requirements/source	-25.8	-17.2	-6.0	-6.0	1.0
Per cent of GDP					
Budgetary revenues	16.5	16.8	17.0	16.5	16.6
Program spending	15.9	14.4	13.7	12.7	11.9
Operating balance	0.6	2.4	3.3	3.8	4.7
Public debt charges	5.6	6.0	5.7	5.5	5.3
Deficit	-5.0	-3.7	-2.4	-2.0	-1.0
Financial requirements/source	-3.5	-2.2	-0.8	-0.7	0.1
Net public debt	73.0	74.0	74.4	73.1	71.2

¹ A positive number indicates a source of funds; a negative number indicates a financial requirement.

Outline of the Budget Plan

Chapter 2 reviews recent economic developments and prospects for Canada. It establishes the economic planning assumptions that underlie the government's fiscal projections. As in past budgets, a cautious base for fiscal planning is established using the average of private sector forecasts, with an added degree of prudence to interest rates and nominal GDP growth.

Chapter 3 describes the fiscal progress achieved to date and the payoff that is being realized. It sets out why the government must continue to stay the fiscal course and why it is necessary to ensure a continuing decline in the debt-to-GDP ratio. The chapter also summarizes the cost of measures announced in this budget, and the fiscal outlook based on prudent economic assumptions. The chapter shows that the government will substantially better its deficit target this year, and meet its fiscal targets for 1997-98 and 1998-99.

Chapter 4 deals with the jobs challenge. It describes the government's jobs strategy and the actions that have been taken to date to promote economic growth and job creation. It describes new initiatives taken in this budget to further encourage growth and employment in the near to medium term, as well as strategic investments in education and innovation to position the Canadian economy for the 21st century.

Chapter 5 describes how the government is also building for the future through key investments in a stronger society. The chapter addresses the challenge of strengthening Canada's health care system. It proposes a further enhancement of the Child Tax Benefit as a step towards a National Child Benefit System. It also proposes increased assistance for the disabled and actions designed to further encourage charitable giving.

Annex 1 describes three different measures of the federal fiscal position: the budget deficit, financial requirements and the national accounts deficit, and provides a discussion and reconciliation of the three measures. Annex 2 provides an update of the fiscal situation of the total government sector in Canada. Annex 3 describes the fiscal sensitivity to changes in economic growth and interest rates. Annex 4 describes the government's response to the *1996 Report of the Auditor General of Canada* and observations on Canada's financial statements, and Annex 5 highlights aspects of, and describes actions taken to improve, the fairness of Canada's tax system. Annex 6 provides supplementary information on tax measures contained in this budget.

Economic Developments and Prospects: Assumptions for Fiscal Planning¹

Introduction

This chapter reviews recent economic developments and presents the economic assumptions for 1997 and 1998 on which fiscal planning is based.

Although average growth in 1996 was lower than expected, owing mainly to slow growth during the first half of the year, developments in the latter months of 1996 have been very encouraging for 1997 and beyond. Interest rates fell to levels substantially below expectations at the time of the 1996 budget. Short-term rates dropped more than 200 basis points during 1996, and have been below comparable U.S. rates for the longest sustained period in two decades. The substantial easing of monetary conditions that took place through last year has laid the foundation for much stronger growth and job creation in 1997 and 1998.

The decline in interest rates reflects the marked improvement in the fiscal health of the federal and provincial governments and the turnaround in economic fundamentals in recent years. Deficits have been cut sharply and inflation held to a low level, while Canada's competitiveness has improved. By mid-year, the current account had moved into surplus for the first time in 12 years.

These developments have translated into a marked improvement in confidence in the country. Only a short time ago, investor confidence in Canada was at a low ebb, owing to years of deterioration in Canada's public finances. The result was upward pressure on

¹ All statistical references as of Wednesday, February 12, 1997.

interest rates at a time when easier monetary conditions were needed to address slow growth and high unemployment. High interest rates compounded Canada's fiscal problems. The decisive measures adopted by governments all across Canada have broken this vicious cycle, boosting confidence and creating the conditions for lower interest rates and stronger growth in the years ahead.

Private sector forecasters are now unanimous in forecasting faster growth and job creation for Canada. Major international organizations, such as the International Monetary Fund (IMF) and Organization for Economic Co-operation and Development (OECD), share this favourable assessment of the Canadian economy's growth prospects.

For fiscal planning purposes, the government will continue its practice of adopting prudent economic assumptions. This approach was implemented on the advice of the Round Table of private sector economists held in December 1993, and on the recommendation of the House of Commons Standing Committee on Finance. They recommended that budget planning be based on interest rate assumptions above the average of private sector forecasts and, as a result, lower nominal gross domestic product (GDP) growth. The purpose of this approach was to guard against the possibility that a less favourable economic environment might prevent the government from meeting its fiscal targets – a development that would be very costly to the economy at a time when fiscal credibility needed to be re-established.

Recent Developments and Outlook

Recent developments

During the first half of last year, expectations for 1996 growth were steadily revised down as successive indicators showing continued weakness in the economy were released. At the time of the 1996 budget, private sector forecasters expected growth to average 1.9 per cent in 1996. It now appears likely that growth for 1996 averaged about 1.4 per cent.

The slower growth recorded for 1996 as a whole mainly reflected sluggishness during the first half of the year. This stemmed in part from the need of businesses to reduce inventories, which had risen to undesirably high levels in early 1995. Growth strengthened in the second half of last year, however, following the end of the inventory correction and as lower interest rates began to take effect.

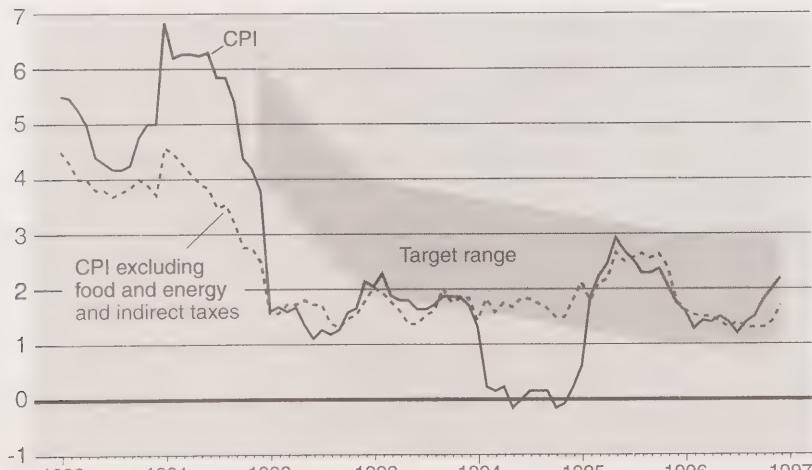
Stronger growth expected in 1997 and beyond

There are good reasons to believe that growth has begun to strengthen, and that this will continue through 1997 and beyond. These stronger growth prospects stem from a fundamental improvement in confidence, owing in large measure to the turnaround in Canada's fiscal situation and continued low inflation. Federal and provincial governments have demonstrated their resolve to tackle their deficit problems. This greatly reduced their borrowing requirements and subsequent use of private savings so much so that Canada's chronic current account deficit (a measure of the country's need for foreign savings) has been largely eliminated. Inflation has been kept within the 1 to 3 per cent target range established jointly by the government and the Bank of Canada, thereby anchoring expectations for continued low inflation (Chart 2.1).

Chart 2.1

Consumer price index (CPI)

year-over-year per cent change



Note: The underlying rate of inflation is well within the official target range of between 1 and 3 per cent.

The improvement in confidence is clearly illustrated by the steep decline in interest rates over the last two years. When the government took office, the poor state of Canada's public finances had eroded investor confidence to a degree that Canadians,

including the government, had to borrow at rates well above those in the U.S. These high interest rates in turn compounded Canada's fiscal problems.

The decisive measures adopted by governments all across Canada have broken this vicious cycle. The improvement in investor confidence has translated concretely into lower interest rates across all maturities. Short-term interest rates are now at their lowest level in close to 35 years. Moreover, interest rate spreads vis-à-vis key U.S. rates have narrowed sharply across the maturity spectrum. Canadian rates are now lower than those in the U.S. on maturities of up to about 10 years (Chart 2.2). Short-term rates have been below those in the U.S. for the longest sustained period in two decades. For example, the three-month Treasury bill rate, which has been below the comparable U.S. rate for almost 12 months, is currently more than 200 basis points below U.S. rates (Chart 2.3). This large negative interest rate spread stands in marked contrast to the positive spread of more than 200 basis points that has prevailed on average over the last 20 years.

Chart 2.2
Canada-U.S. yield curve spreads

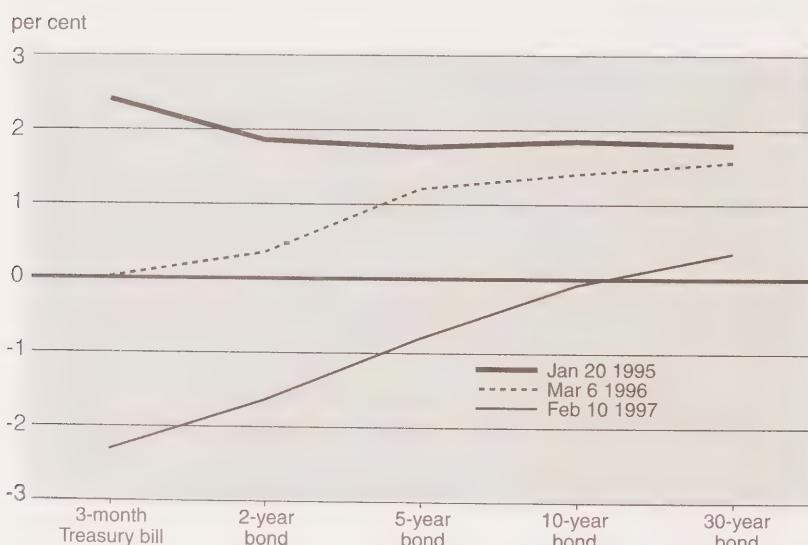
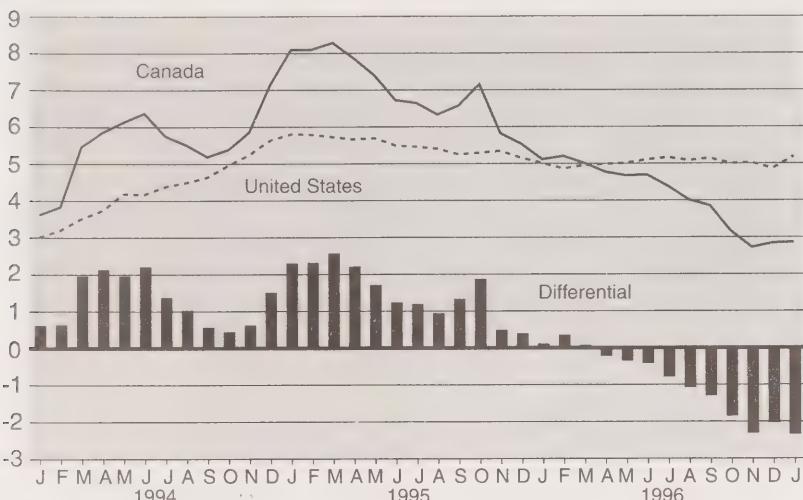


Chart 2.3*3-month Treasury bill rates*

per cent



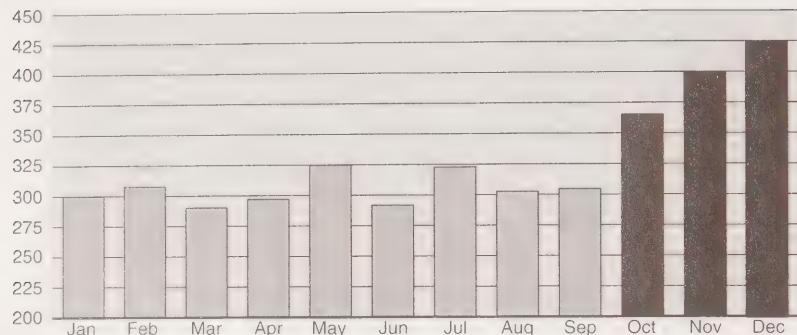
The U.S. Treasury bill rate has been adjusted from a discount basis to a true-yield basis.

Lower government bond yields have passed through to the interest rates at which businesses and households borrow: the prime rate is now 4.75 per cent, its lowest level in 40 years; mortgage and consumer loan rates have also fallen significantly. One-year mortgage rates are currently just over 5 per cent, down nearly 500 basis points from January 1995, while five-year rates have fallen some 350 basis points to about 7½ per cent. These lower mortgage rates provide substantial savings in terms of lower mortgage payments. The decline in the one-year mortgage rate, for example, means that a homeowner taking out a \$100,000 mortgage amortized over 25 years pays about \$3,600 less per year than if rates had remained constant. And lower mortgage rates allow homeowners to pay off their mortgages faster. When the five-year mortgage rate peaked in January 1995, a \$100,000 mortgage amortized over 25 years cost almost \$950 per month. With current mortgage rates, a homeowner paying \$950 per month could eliminate the same \$100,000 mortgage in only 14 years.

Chart 2.4*Developments in late 1996 show a strengthening economy*

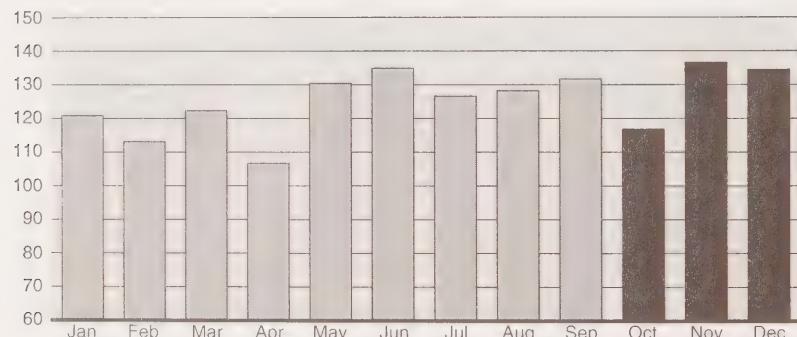
MLS house resales

thousands, annual rate



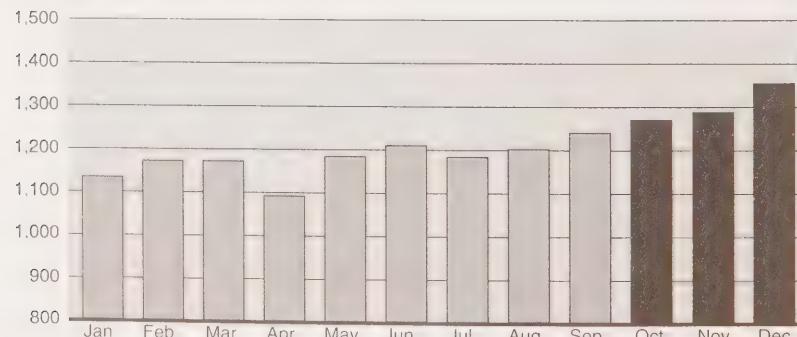
Housing starts

thousands, annual rate



Motor vehicle sales

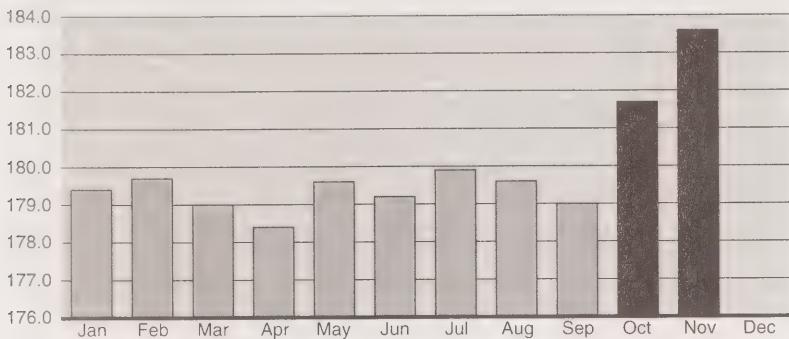
thousands, annual rate



Developments in late 1996 show a strengthening economy

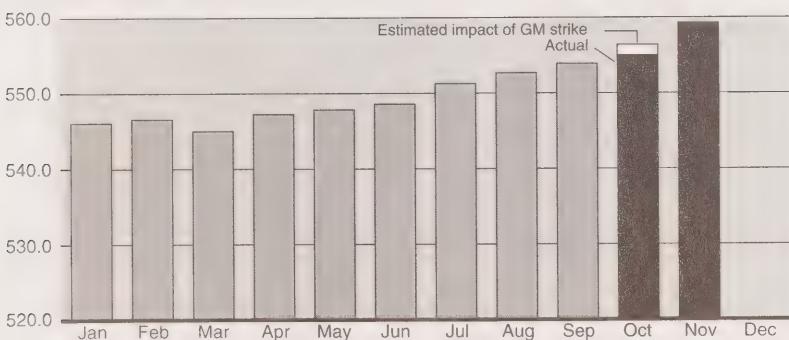
Real consumer spending on goods

\$1986 millions, annual rate



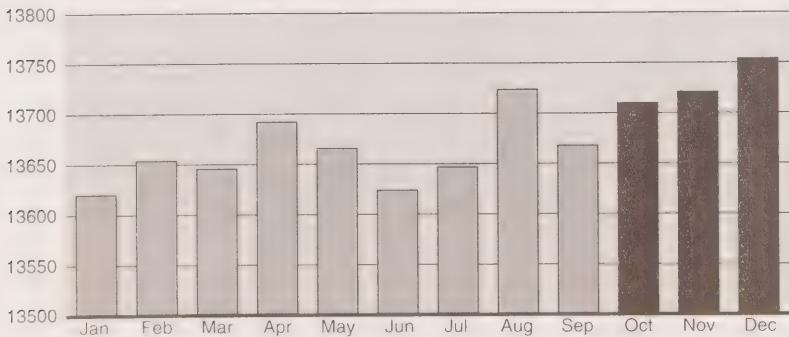
Real monthly GDP

\$1986 millions, annual rate



Employment

thousands



Since the effects of interest rates on economic activity are subject to considerable lags, the declines in interest rates achieved in 1995 and early 1996 only began to have a marked effect on consumer spending and investment in the fall of 1996 (Chart 2.4). Naturally, the effect of low interest rates has appeared first in the most interest-sensitive sectors:

- For example, house resales were soaring in late 1996, reducing the inventory of unsold houses and boosting housing starts. By January 1997, housing starts were up nearly 50 per cent from their mid-1995 low.
- Business confidence has never been better. Businesses are using more of their capacity and expect their financial position to improve over the next six months. As a result, the share of businesses that think now is a good time to invest has reached its highest level on record. It is therefore not surprising that business investment jumped over 20 per cent in the third quarter of 1996.
- Consumer confidence rose strongly in the fourth quarter – the fourth consecutive quarter of improvement. Sales of durable goods rose strongly in the fourth quarter of 1996; new motor vehicle sales, for example, increased 8 per cent in the fourth quarter.
- Job creation has picked up with the economy generating 91,000 additional jobs in the last four months.

Much of the very sharp declines in interest rates we have seen in the past two years only occurred in the second half of 1996. Given the usual lags in the effects of changing monetary conditions, this implies that there is significant stimulus to growth and jobs still to come from declines in interest rates and the substantial improvement in consumer and business confidence.

Stronger demand will fuel the growth needed to get Canadians back to work. Private sector job creation has been healthy, with 231,000 jobs having been created since the end of 1995. Overall job creation has been slower, owing to public sector job losses, but total employment nonetheless expanded by 191,000 over the same period. Roughly eight out of ten of these jobs are full-time.

Stronger employment growth during 1997 will in turn generate the income gains and confidence required to fuel the consumption and residential investment needed to continue the expansion and make it more balanced.

The Outlook: Updating the Planning Assumptions

These developments, as well as a more favourable external environment, have led private sector forecasters to expect stronger growth in 1997, both relative to the performance in 1996 and earlier expectations for 1997.

The external environment

The external environment is expected to support stronger economic growth in Canada and the continuing efforts by all levels of government to put public finances on a strong and sustainable footing.

Major overseas economies

Growth in the major European economies is expected to strengthen in 1997 and to improve further in 1998. The improvement in growth prospects reflects the effect of a steady decline in interest rates over the past several years.

Japan's economy is expected to slow in 1997, reflecting the short-run impact of measures required to contain large budget deficits. However, the outlook is for stronger growth in 1998.

Inflationary pressures are under control in all major overseas economies, a development which provides monetary authorities with considerable scope to maintain interest rates at their present accommodative levels.

Table 2.1

Outlook for economic growth in the major overseas economies

	1996	1997	1998
(per cent)			
Japan	3.6	1.6	3.7
Germany	1.1	2.2	2.6
France	1.3	2.5	2.6
United Kingdom	2.4	3.3	3.0
Italy	0.8	1.2	2.1

Source: OECD *Economic Outlook*, December 1996.

The United States

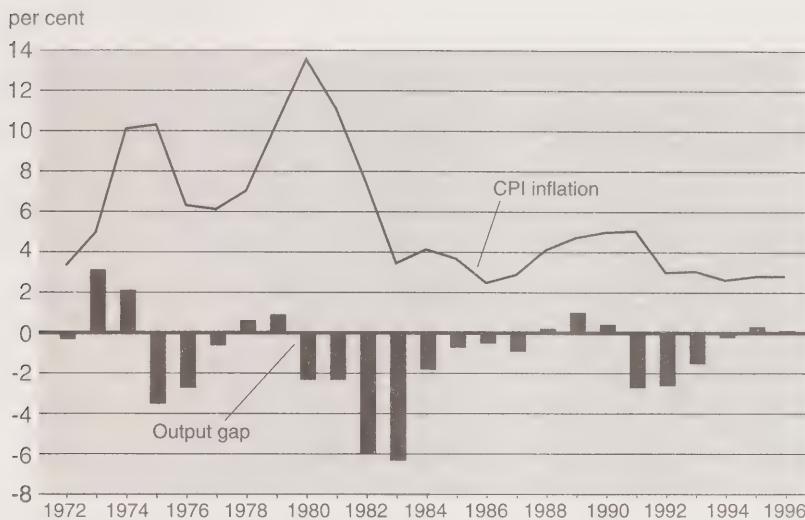
The U.S. economy expanded at a pace somewhat greater than the growth in its productive capacity during 1996. However, the consensus among private forecasters and major international organizations is for 1997 to see the U.S. economy growing at a rate in line with its productive potential, and for inflation to remain roughly constant at about 3 per cent. One of the main factors expected to restrain future growth is the rise in long-term market interest rates during the first half of 1996. Since changes in interest rates affect economic activity with lags, the impact of higher long-term rates will not be felt in full until 1997. This view, together with the absence of an upward trend in inflation, was likely behind the Federal Reserve Board's decision not to raise short-term interest rates in 1996.

Table 2.2
U.S. economic outlook

	1996	1997	1998
		(per cent)	
Real GDP	2.5	2.3	2.1
Consumer prices	2.9	2.9	3.0
3-month Treasury bill rate	5.0	5.2	5.1
10-year government bond rate	6.4	6.4	6.4

Source: Blue Chip Economic Indicators, January 10, 1997. This is a survey of approximately 50 private sector forecasters. Values for 1996 are actual data. The three-month Treasury bill rate is on a discount basis.

The fact remains, however, that the U.S. economy has for some time been operating at, and at times slightly beyond, its long-term productive capacity. Periods such as this have in the past usually resulted in inflationary pressures (Chart 2.5). In this environment, the possible emergence of inflationary pressure will remain a concern of the authorities, resulting in a balance of risks that is tilted in the direction of higher U.S. interest rates. In this respect, it is significant that the rise in long-term interest rates during the first half of 1996 has since been partially reversed. As a result, many U.S. analysts believe that the Federal Reserve will need to remain vigilant, and will need to raise short-term interest rates in 1997 to ensure that inflationary pressures do not emerge.

Chart 2.5*U.S. output gap and inflation*

Note: The output gap is calculated as the per cent difference between actual and potential GDP, as calculated by the Congressional Budget Office. Data are for U.S. government fiscal years.

The economic assumptions for Canada

Private sector views

The consensus among Canadian private sector forecasters is that growth will strengthen and become more broadly based in 1997, expanding from the export sector to domestic demand beginning with the most interest-sensitive components. Stronger and more balanced demand will spur faster job creation, a development that will in turn help generate yet stronger domestic demand. This virtuous circle will operate both directly – through faster growth in household income – and indirectly – through further improvement in consumer confidence.

As well, Canada's strong competitive position, which is steadily being reinforced by continued fiscal progress and by the government's success in controlling inflation, will help ensure that exporters retain the gains they have made in recent years.

The most striking, and encouraging, difference between these recent private sector forecasts and those presented in the 1996 budget relates to the outlook for interest rates. The consensus among forecasters is for the three-month Treasury bill rate to average 3.2 per cent in 1997, rising only slightly to 3.7 per cent in 1998.

The expected increase from current rates reflects some expectations for modest increases in U.S. short-term interest rates and some narrowing of the present large negative spread between Canadian and U.S. rates. Nonetheless, this represents a clear contrast with the situation one year ago, when forecasters expected short-term rates to average 5.8 per cent in 1997. Canadian 10-year government bond yields are expected to remain roughly equal to U.S. rates at around 6.6 per cent in 1997. Again, the progress achieved over the past year stands out. A year ago, forecasters expected long-term yields to average 7.4 per cent.

The downward revision to private sector forecasts of interest rates has been accompanied by an improved outlook for GDP and employment growth in 1997 (Chart 2.6). Growth is expected to strengthen to 3.3 per cent in 1997 from an estimated 1.4 per cent in 1996, compared with the private sector forecast of 2.8 per cent growth for 1997 presented in the 1996 budget. Employment is expected to grow by 2.0 per cent in 1997, compared with the private sector consensus of 1.8 per cent prevailing prior to last year's budget. Many private sector forecasters expect that this stronger growth could generate between 300,000 and 350,000 jobs by the end of this year.

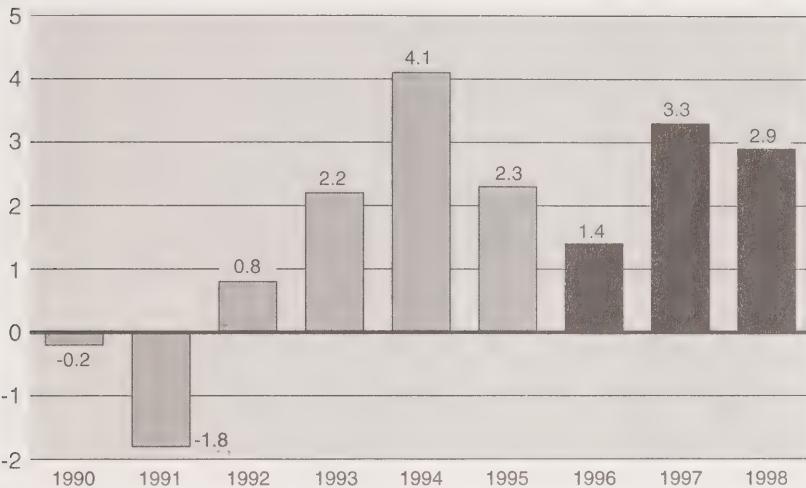
The consensus among Canadian private sector forecasters is for Canada's current account surplus to rise over the next several years, a development that will help sustain the conditions for continued low interest rates.

Major international organizations share this favourable assessment of the Canadian economy's growth prospects. The most recent forecasts by the IMF and the OECD project that Canada, together with the United Kingdom, will achieve the strongest economic growth among the G-7 economies in 1997, with the IMF and OECD projecting growth of 3.2 per cent, and 3.3 per cent, respectively.

Chart 2.6a*Private sector outlook for 1997 and 1998*

Growth in real GDP

per cent

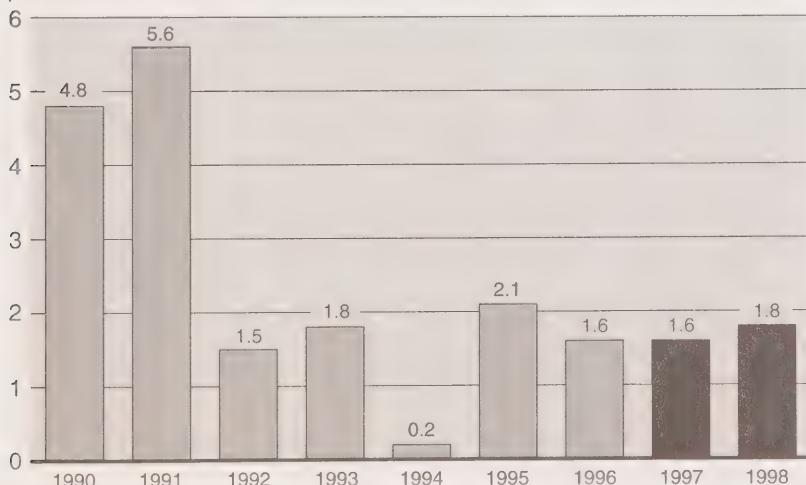


Source: January 1997 survey of private sector forecasters.

Chart 2.6b*Private sector outlook for 1997 and 1998*

CPI inflation

per cent



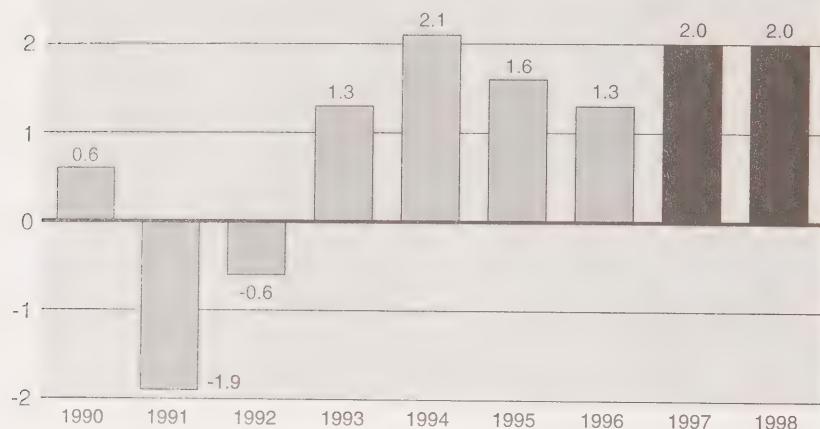
Source: January 1997 survey of private sector forecasters.

Chart 2.6c*Private sector outlook for 1997 and 1998*

Employment growth

per cent

3



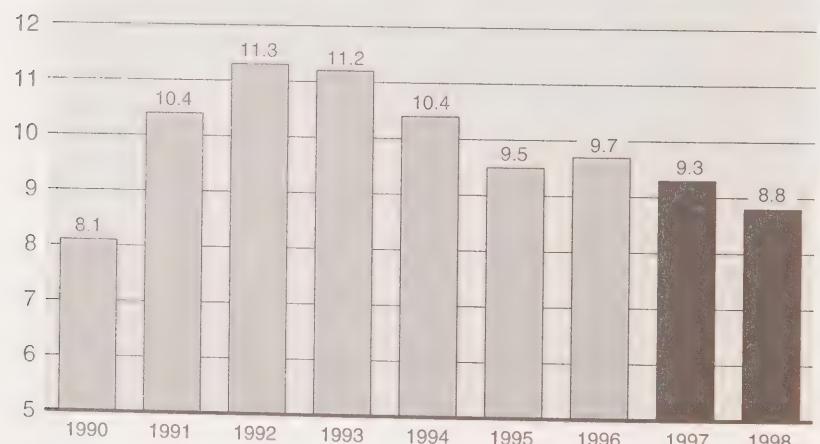
Source: January 1997 survey of private sector forecasters.

Chart 2.6d*Private sector outlook for 1997 and 1998*

Unemployment rate

per cent

13



Source: January 1997 survey of private sector forecasters.

Table 2.3*Evolution of private sector forecasts since the 1996 budget*

	1996	1997	1998
Real GDP growth (%)			
February 1996	1.9	2.8	
September 1996	1.5	3.1	
January 1997	1.4	3.3	2.9
CPI inflation rate (%)			
February 1996	1.7	2.1	
September 1996	1.5	1.7	
January 1997	1.6	1.6	1.8
Nominal GDP (\$ billion)			
February 1996	809	846	
September 1996	797	834	
January 1997	798	837	876
Employment growth (%)			
February 1996	1.3	1.8	
September 1996	1.4	1.9	
January 1997	1.3	2.0	2.0
Unemployment rate (%)			
February 1996	9.4	9.1	
September 1996	9.5	9.2	
January 1997	9.7	9.3	8.8
3-month Treasury bill rate (%)			
February 1996	5.3	5.8	
September 1996	4.5	4.5	
January 1997	4.2	3.2	3.7
10-year government bond rate (%)			
February 1996	7.2	7.4	
September 1996	7.6	7.5	
January 1997	7.2	6.6	6.6

The February 1996 survey was based on 20 respondents for 1996 and 18 for 1997. The September 1996 survey was based on 15 respondents for both years. The January 1997 survey was based on forecasters who had updated their forecasts since the release of the *Canadian Income and Expenditure Accounts* for the third quarter of 1996. Twenty-one forecasters provided projections for 1997 and 18 forecasters provided projections for 1998. The January 1997 survey data for 1996 reflect actual outcomes, with the exception of GDP, which is a private sector estimate.

Prudent assumptions for fiscal planning

The prudence factors for fiscal planning assumptions at the time of the October *Economic and Fiscal Update* were for short-term interest rates 80 basis points higher than the private sector average in 1997, and for long-term interest rates 50 basis points higher than forecast by the private sector. These assumptions were seen as appropriate by the economists appearing before the House of Commons Standing Committee on Finance. Accordingly, the 1997 budget will retain these planning assumptions for 1997, and extend them into 1998.

The reasons supporting the application of these prudence factors are those identified in the October *Economic and Fiscal Update*:

- With the U.S. economy operating at its productive capacity, there is a risk that stronger economic growth or incipient inflationary pressure might result in a greater-than-expected increase in interest rates by the Federal Reserve Board. There is always the risk that such an increase in U.S. rates could spill over into Canada in the form of higher Canadian interest rates.
- The smaller prudence factor applied to long-term interest rates reflects the unusual steepness of the Canadian yield curve. As long-term interest rates are already unusually high compared to short-term rates, they may not rise commensurately with any future increase in short rates.

The application of these prudence factors results in a level of nominal GDP that is 0.2 per cent lower in 1997 than forecast by the private sector and 0.7 per cent lower in 1998.

Table 2.4
Economic assumptions for the 1997 budget¹

	1996	1997	1998
Real GDP growth (%)			
Private sector average	1.4	3.3	2.9
1997 budget	1.4	3.2	2.6
Nominal GDP growth (%)			
Private sector average	2.7	4.9	4.7
1997 budget	2.7	4.7	4.1
Nominal GDP (\$ billion)			
Private sector average	798	837	876
1997 budget	798	835	870
3-month Treasury bill rate (%)			
Private sector average	4.2	3.2	3.7
1997 budget	4.2	4.0	4.5
10-year government bond rate (%)			
Private sector average	7.2	6.6	6.6
1997 budget	7.2	7.1	7.1

¹ GDP data for 1996 are estimates.

Table 2.5
Change in prudent economic assumptions for budget planning¹

	1996	1997	1998
Real GDP growth (%)			
1996 budget	1.8	2.6	
October update	1.5	3.0	
1997 budget	1.4	3.2	2.6
Nominal GDP growth (%)			
1996 budget	3.3	4.3	
October update	2.7	4.4	
1997 budget	2.7	4.7	4.1
Nominal GDP (\$ billion)			
1996 budget	806	841	
October update	797	832	
1997 budget	798	835	870
3-month Treasury bill rate (%)			
1996 budget	5.8	6.6	
October update	4.5	5.3	
1997 budget	4.2	4.0	4.5
10-year government bond rate (%)			
1996 budget	7.7	8.2	
October update	7.6	8.0	
1997 budget	7.2	7.1	7.1

¹ 1997 budget GDP data for 1996 are estimates.

3

Building the Future: Staying the Fiscal Course

Introduction

Restored fiscal health is critical to Canada's economic prosperity and social well-being.

Entrepreneurial vigour, a vibrant investment climate and confident consumers are the hallmarks of a strong and growing economy. But when the government took office, these essential elements of Canada's well-being were threatened by rapidly deteriorating public finances. The accumulation of debt over the previous 20 years had become an impediment to Canada's economic performance. It also posed a real threat to the sustainability of public health care and other valued programs that are the very fabric of Canada.

The fiscal strategy set out in the last three budgets has changed this situation. Not only has the fiscal turnaround been significant, the emphasis on *getting government right* has been important as well. The payoff from this fiscal turnaround is emerging, in the form of lower interest rates, improved confidence, and renewed growth and employment prospects. For that payoff to be sustained, fiscal progress must continue.

Restored fiscal health is not an end in itself. The pursuit of deficit reduction at any cost would have an unduly negative impact on the economy and on Canadians themselves. The government has balanced firm and sustained fiscal progress with the need to address critical economic and social concerns. High priority programs have

been protected relative to others in budget reductions, and reallocations have been undertaken to fund key investments and selective tax changes.

The Fiscal Plan is on Track

Each of the government's budgets has built upon its predecessors in achieving the reforms necessary to secure lasting fiscal health.

The strategy has been successful. The fiscal progress achieved to date has been significant.

- The 1994-95 and 1995-96 deficit targets were both bettered (Chart 3.1). Last year, the deficit fell to \$28.6 billion from \$37.5 billion in 1994-95.
- This left the deficit-to-GDP ratio at 3.7 per cent in 1995-96, its lowest level since 1976-77.

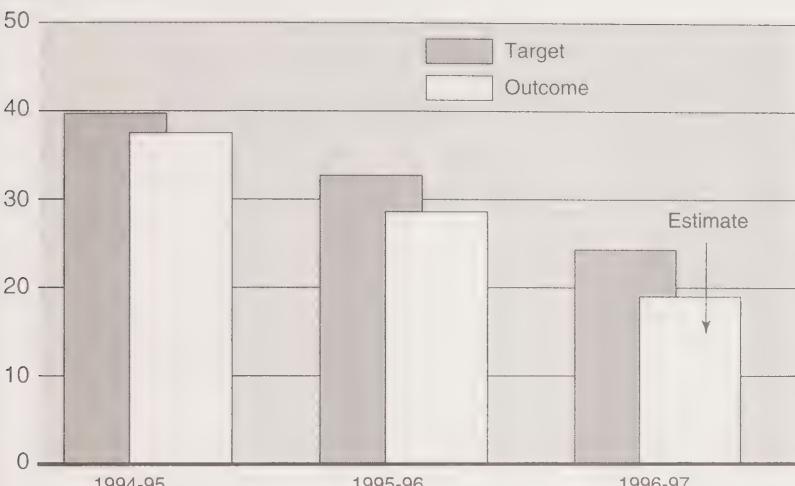
Deficit below target in 1996-97

Data available to the end of December 1996 (see *The Fiscal Monitor* for December 1996) indicate that the deficit target of \$24.3 billion for 1996-97 will be bettered. Based on these results, the deficit will be no higher than \$19 billion – at least \$5.3 billion below target (Table 3.1).

- At no more than \$19 billion, or 2.4 per cent of gross domestic product (GDP), the deficit will have been cut by more than half in three years, and the deficit target will have been bettered three years in a row (Chart 3.1).

Chart 3.1*Deficit targets and outcomes*

billions of dollars



The better outcome is primarily due to a number of factors:

- The decline in interest rates witnessed in 1996 means that public debt charges will be \$2.3 billion lower than forecast in the 1996 budget.
- Program spending is expected to be unchanged from the March 1996 budget level, even after including the proposed one-time payment of \$800 million to the new Canada Foundation for Innovation.
- Budgetary revenues are expected to be slightly higher than estimated in the March 1996 budget, as the impact of slower-than-expected economic growth in 1996 is more than offset by two special factors – acceleration of employment insurance (EI) premiums and the net proceeds from the sale of the air navigation system.
- As a result of these developments, the Contingency Reserve of \$2.5 billion will not be required.

Final deficit results for 1996-97 will be published in the *Annual Financial Report*.

Table 3.1

*Summary statement of transactions:
fiscal outlook with budget measures¹*

	1994-95	1995-96	1996-97	1997-98	1998-99
(billions of dollars)					
Budgetary revenues	123.3	130.3	135.5	137.8	144.0
Program spending	118.7	112.0	109.0	105.8	103.5
Operating balance	4.6	18.3	26.5	32.0	40.5
Public debt charges	42.0	46.9	45.5	46.0	46.5
Underlying deficit	-37.5	-28.6	-19.0	-14.0	-6.0
Contingency Reserve				3.0	3.0
Deficit	-37.5	-28.6	-19.0	-17.0	-9.0
Net public debt	545.7	574.3	593.3	610.3	619.3
Non-budgetary transactions	11.6	11.4	13.0	11.0	10.0
Financial requirements/source	-25.8	-17.2	-6.0	-6.0	1.0
Per cent of GDP					
Budgetary revenues	16.5	16.8	17.0	16.5	16.6
Program spending	15.9	14.4	13.7	12.7	11.9
Operating balance	0.6	2.4	3.3	3.8	4.7
Public debt charges	5.6	6.0	5.7	5.5	5.3
Deficit	-5.0	-3.7	-2.4	-2.0	-1.0
Financial requirements	-3.5	-2.2	-0.8	-0.7	0.1
Net public debt	73.0	74.0	74.4	73.1	71.2

¹ A positive number indicates a source of funds, a negative number indicates a financial requirement.

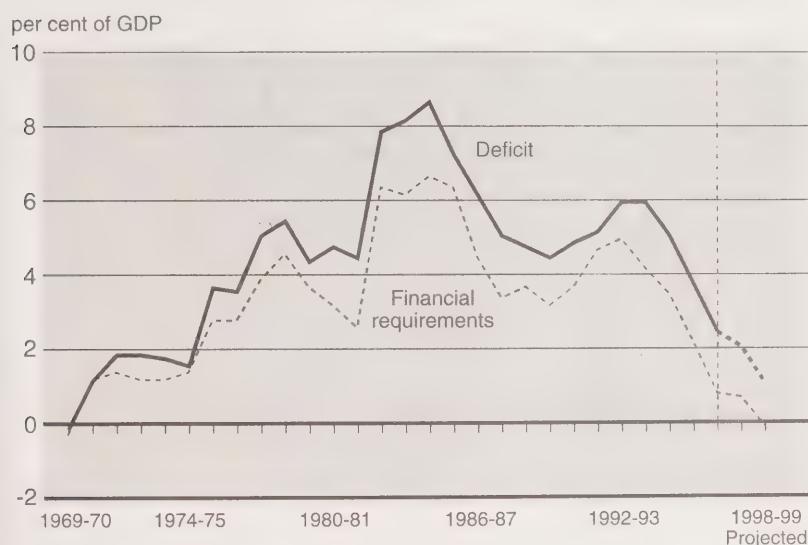
Deficit targets for 1997-98 and 1998-99 will be met

The fiscal projections for 1997-98 and 1998-99 are based on the prudent economic planning assumptions described in Chapter 2. The government is backing these planning assumptions with substantial Contingency Reserves – \$3.0 billion in both years.

The fiscal impact of the restraint measures taken in the 1994, 1995 and 1996 budgets continues to grow over the planning period, exerting incremental downward pressure on program spending. This, coupled with the revenue flowing from the forecast growth in the economy, will ensure that the deficit targets for 1997-98 and 1998-99 will clearly be met. If the Contingency Reserves are not needed, they will not be spent, reducing the deficit in these years even further.

- Staying the course in this budget confirms that the deficit is clearly on track to achieve the targets of \$17 billion for 1997-98 and \$9 billion for 1998-99.
- Financial requirements – the amount of new money the government has to borrow on credit markets – will be in a small surplus by 1998-99 (Chart 3.2). The last time financial requirements were in balance or surplus was in 1969-70.

Chart 3.2
Public accounts deficit and financial requirements



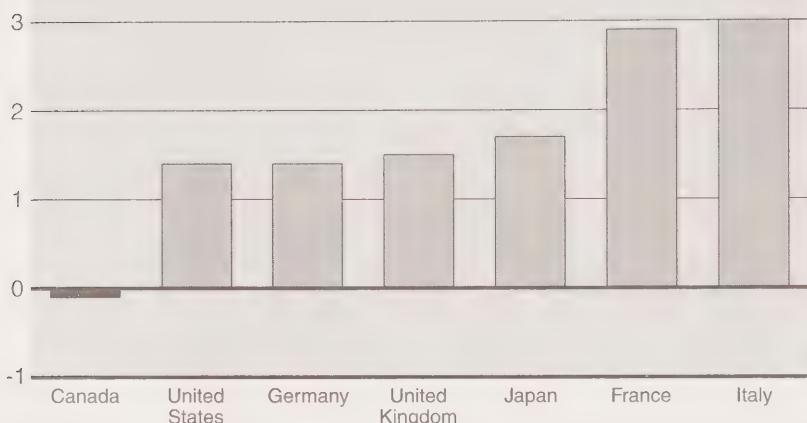
- Financial requirements is the measure used by most other major industrialized countries, such as the U.S., to measure their financial position. On this basis, zero financial requirements would imply a “balanced” budget. Based on the budget plans of the Group of Seven (G-7) countries, Canada will be alone in having achieved this milestone in 1998-99 (Chart 3.3).
- The operating balance (revenues less program spending) will be in a surplus amounting to 3.3 per cent of GDP this year, and this surplus will reach 4.7 per cent of GDP by 1998-99 – the highest ratio in 50 years. If it were not for interest costs on the debt, the federal budget would now be in a large surplus position (Chart 3.4).

Chart 3.3

*Projected 1998 G-7 financial requirements
(central government)*

per cent of GDP

4



Source: National budget plans.

Chart 3.4

Evolution of the federal deficit

billions of dollars

60

40

20

0

-20

-40

-60

1969-70

1979-80

1989-90

1998-99

Projected

Operating balance

Interest on
the public debt

Deficit

For many years, the federal government was caught in a vicious debt trap. Higher deficits pushed up the debt-to-GDP ratio, which in turn pushed up interest rates, resulting in even more upward pressure on the deficit. This debt trap has now been broken. Lower debt servicing charges will now complement measures already put in place to control spending and increase the operating surplus.

Beginning in 1997-98, economic growth is expected to outpace the growth in the debt, and the debt-to-GDP ratio will begin to decline. This decline will continue in 1998-99. The debt-to-GDP ratio has risen, virtually without interruption, over the last two decades, because the growth in the debt consistently outstripped the growth in GDP – the capacity of the economy to carry that debt.

The Strategy to Restore Fiscal Health

Just as important as what has been accomplished is how it has been accomplished. The government's strategy to restore fiscal health has been clear and consistent.

- The pace of deficit reduction has been deliberate, measured and responsible – to ensure that the program reforms and savings are permanent, while allowing Canadians and the economy time to adapt.
- Deficit reduction has been pursued using two-year rolling deficit targets.
- These targets have been based on prudent economic planning assumptions backed by a substantial Contingency Reserve.

The Contingency Reserve

The Contingency Reserve is included in the deficit projections primarily to cover risks arising from (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and (ii) unpredictable events. The Contingency Reserve also provides an extra measure of back-up against adverse errors in the economic forecast. **The Contingency Reserve is not a source of funding for new policy initiatives.**

- Budget savings have been secured principally from expenditure reductions rather than tax increases. This is true whether measured in terms of budget savings, or in terms of the contributions to deficit reduction over time from expenditure and revenue growth.

The strong reliance of budget savings on expenditure reductions rather than tax increases has been critical to the government's fiscal strategy.

Research in Canada and elsewhere, such as the International Monetary Fund, has shown that fiscal restraint arising from expenditure savings is more successful in achieving both growth and a permanent improvement in the fiscal situation than that arising from revenue increases.

Program reforms underlying expenditure reduction have modernized the federal government's role in the economy. In the area of economic development, the federal government is focusing increasingly on framework polices rather than on direct program delivery. The government is also increasingly delivering services in partnership with the private sector – using scarce federal resources to lever additional spending from the private sector – and with the provinces. The benefits of these reforms go far beyond their direct financial impacts; these are structural program reforms that will improve the functioning of the economy.

Actions taken by the government since taking office will have reduced the 1998-99 deficit by \$28.2 billion from what it otherwise would have been. Of this, 91 per cent is due to expenditure reductions (Table 3.2). The cumulative effect of these actions will be to lower net debt by almost \$89 billion from what it would have been otherwise.

By 1998-99, program spending is projected to fall to \$103.5 billion from \$120.0 billion in 1993-94 – a decline of 13.8 per cent. Given the severity of the fiscal situation, all major components of program spending have been affected.

Table 3.2*Direct net budget savings since 1993-94*

	1994-95	1995-96	1996-97	1997-98	1998-99	Cumulative effect on net debt ¹
	(billions of dollars)					
1994 budget	1.5	8.0	10.9	11.9	12.6	44.9
1995 budget		5.0	10.6	13.3	13.8	42.7
1996 budget ²			0.0	0.9	2.5	3.4
1997 budget ³			-0.8	-1.0	-0.7	-2.5
Total	1.5	13.0	20.7	25.1	28.2	88.5
of which:						
Program spending	0.7	10.6	18.1	22.8	25.6	77.8
Revenues	0.8	2.4	2.6	2.3	2.6	10.7

¹ Direct fiscal impact only. Does not include savings on public debt charges associated with lower borrowing requirements.

² Includes 1996 EI reform. Fiscal impact of the proposed reform of Seniors' Benefits only appears after 2001.

³ Includes measures announced since the 1996 budget.

(+) sign indicates a reduction in the deficit and net debt.

(-) sign indicates an increase in the deficit and net debt.

Excluding transfers to persons (seniors and employment insurance benefits) and to other levels of government (mainly the Canada Health and Social Transfer and Equalization), all other spending is projected to decline by about 14 per cent over the 1993-94 to 1998-99 period. Through the Program Review exercises, all aspects of departmental spending were rationalized to ensure that the government's resources are directed to the highest priorities and to those areas where the government is best placed to deliver services.

Transfers to persons and other levels of government accounted for 54 per cent of program spending in 1993-94. These transfers were just too large to permit an exemption from overall program reduction. They, too, needed to be reformed to make them more sustainable over the longer term as well as more targeted to ensure that policy objectives were being met.

- Transfers to persons are expected to decline by 1.4 per cent in total over the five-year period. This is solely due to lower employment insurance benefits. The government has reformed the employment insurance program. Benefits have been restructured, thereby reducing many of the disincentives that had built up in the previous system, and allowing more resources to be allocated to active labour market programming. The system of seniors' benefits is to be reformed. Under the new Seniors Benefit, which is to take effect at the turn of the century, the government is proposing a system of consolidated benefit payments that will be fairer and more targeted to those most in need. Given the increased costs that will arise from an ageing population in the decades ahead, it is important that steps be taken now to put the system of seniors' benefits on a more sustainable basis.
- Total transfer entitlements to other levels of government, which include both tax points and cash transfers – the most appropriate measure of federal support – are expected to decline by about 10 per cent, over the 1993-94 to 1998-99 period. These transfers have been restructured and made more sustainable, predictable and flexible. The introduction of the new block-funded Canada Health and Social Transfer (CHST) will give provinces more flexibility to use funds for post-secondary education, health and social assistance and services in line with their own priorities and program needs. The major changes to these transfers did not come into effect until 1996-97, thereby providing the provinces and territories two years to plan for the changes. The 1996 budget put in place a formula to increase CHST entitlements starting in 2000-01 at a rate linked to the growth in the economy, and also put in place a floor to ensure that cash payments, over the period of the current legislated arrangements, never fall below \$11 billion.

To measure the contribution of the major components to the change in the deficit, it is instructive to remove the effect of the changes in the economy. For example, revenues typically increase as the economy expands, as more working Canadians would be paying taxes. By examining changes in revenue and spending as a percentage of the economy (GDP), most of the economic effects can be eliminated, thus clarifying contributions of policy changes.

Chart 3.5 shows the evolution of program spending and revenues as a share of GDP. Although budgetary revenues are expected to increase by \$28 billion over the 1993-94 to 1998-99 period, the revenue-to-GDP ratio is expected to rise only slightly – from 16.3 per cent in 1993-94 to a projected 16.6 per cent in 1998-99. This implies that most of the \$28 billion increase in revenues will be due to the growth in the economy.

Program spending is expected to decline, in absolute terms, by \$16.5 billion over this period. As a percentage of GDP, it is expected to fall from 16.8 per cent in 1993-94 to 11.9 per cent by 1998-99.

Table 3.3 shows the contributions of the changes in program spending and revenues to the reduction in the deficit-to-GDP ratio. The decline in program spending accounts for nearly all the improvement in the deficit over the 1993-94 to 1998-99 period.

Chart 3.5 *Program spending and revenues*

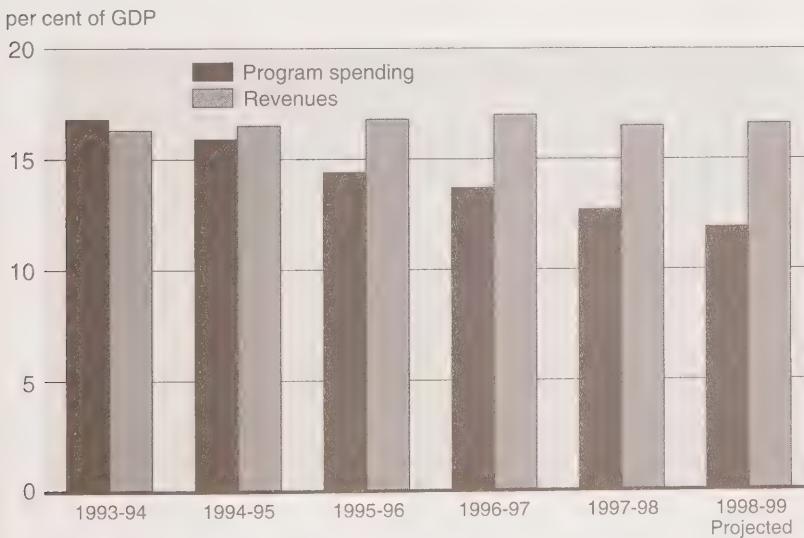


Table 3.3*Change in the deficit-to-GDP ratio from 1993-94 to 1998-99*

	Change (percentage points of GDP)
Decline in the deficit to-GDP-ratio	4.9
of which:	
Decline in program spending	4.9
Increase in revenue	0.3
offset by:	
Change in public debt charges	0.0
Addition of Contingency Reserve	0.3

Between 1993-94 and 1998-99, the deficit is projected to fall from 5.9 per cent of GDP to 1.0 per cent – a decline of 4.9 percentage points. Between 1993-94 and 1998-99, revenues as a share of GDP are expected to increase only marginally, while program spending is projected to decline by 4.9 percentage points – equal to the decline in the deficit over this period. Public debt charges as a percentage of the economy are projected to be unchanged over this period, while the inclusion of the Contingency Reserve adds to the deficit offsetting a small portion of the overall reduction coming from program spending and revenues.

A Fiscal Strategy Complemented by Provincial Action

The fiscal turnaround at the federal level is critical to Canada's health, but is only one part of a more general improvement in the overall government fiscal situation in Canada. While different provinces have adopted different ways of restoring their fiscal health, the end result is that many are now forecasting balanced budgets or budgetary surpluses for the 1996-97 fiscal year. Just three years ago, all provinces were in large deficit positions.

The aggregate provincial-territorial deficit in 1996-97 is expected to be \$9.0 billion, more than 60 per cent lower than its peak in 1992-93. Like the federal government, the provinces and territories have benefited from the sharp reduction in interest rates since early 1995. Provinces that have a larger proportion of their debt in shorter-term securities have benefited the most (Table 3.4).

Table 3.4

*Estimated savings from lower debt charges by province¹
(From January 1995 to December 1996)*

	Millions of dollars	Per cent of expenditures
Newfoundland	16	0.5
Prince Edward Island	3	0.4
Nova Scotia	70	1.5
New Brunswick	45	1.0
Quebec	645	1.6
Ontario	520	0.9
Manitoba	70	1.3
Saskatchewan	18	0.4
Alberta	250	1.8
British Columbia	175	0.9
Total provincial	1,812	1.2

¹ Finance Canada estimates, based on provincial estimated sensitivities to a 100-basis point change in interest rates. Actual provincial savings may differ due to changes in debt strategies.

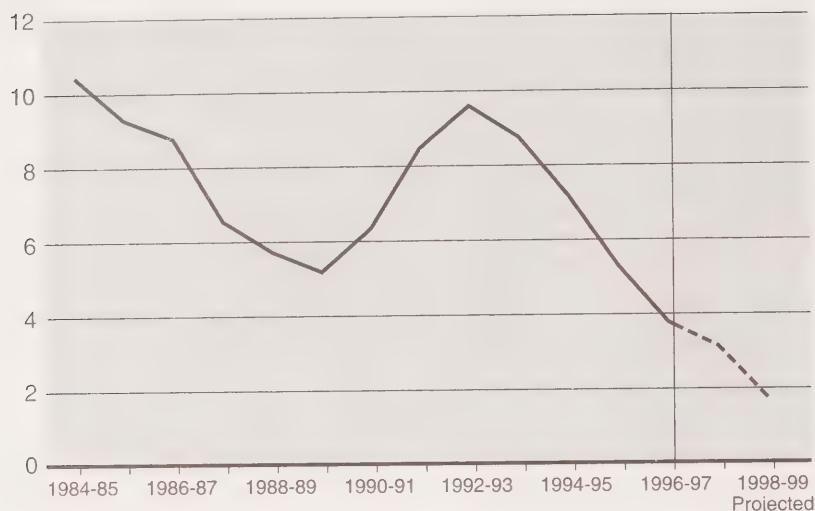
The combined federal-provincial-territorial deficit (on a public accounts basis) is expected to be \$28.0 billion in 1996-97 – down over 57 per cent from its peak in 1992-93. The combined deficit will be about 3 per cent of GDP in 1997-98, compared with 9.6 per cent in 1992-93 (Chart 3.6). Based on current budget plans, it is projected to fall to under 2 per cent of GDP in 1998-99 (see Annex 2 for more details).

Progress in deficit reduction has meant that the net debt-to-GDP ratio will stabilize or decline in most provinces. Combined with progress at the federal level, this means that, by 1997-98, the combined federal-provincial-territorial debt ratio will also be on a downward track (Chart 3.7).

Chart 3.6

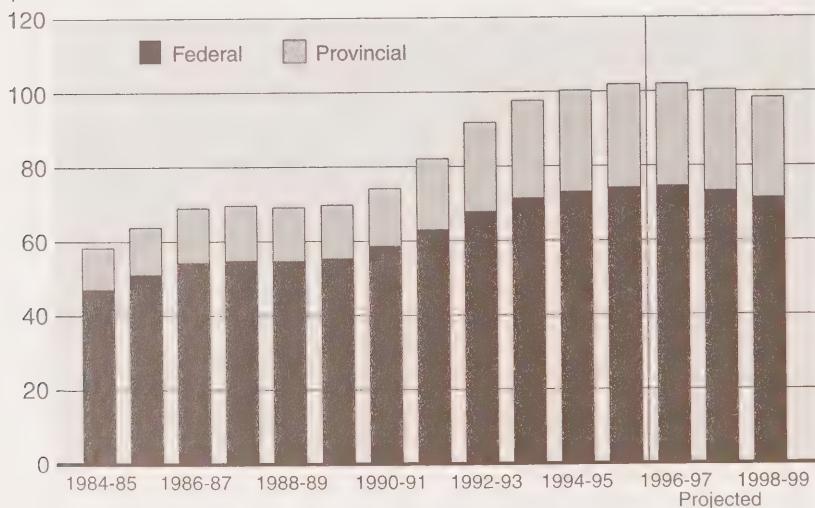
*Federal-provincial government deficit
(public accounts basis)*

per cent of GDP

**Chart 3.7**

*Net debt: federal and provincial governments
(public accounts basis)*

per cent of GDP



Staying the Fiscal Course

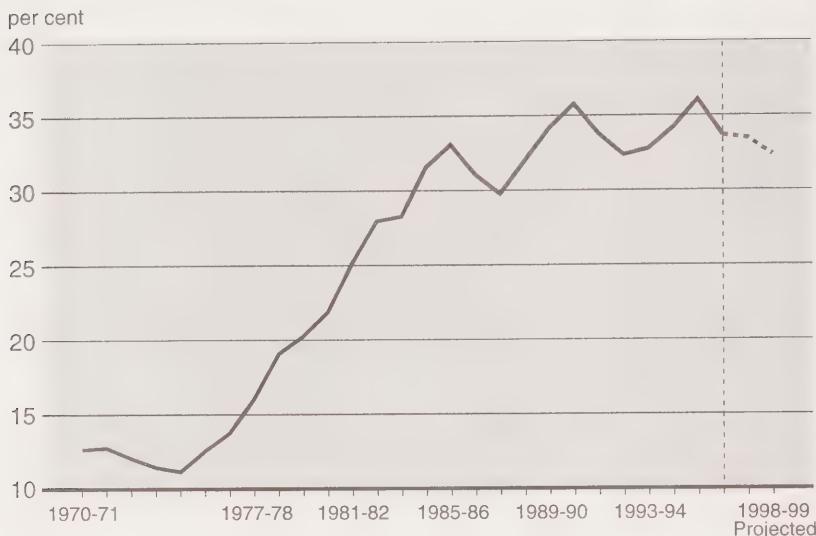
While the actions taken in the government's first three budgets have helped the federal fiscal situation turn the corner, it is premature to declare victory.

The government recognizes that the very credibility that has contributed to a significant decline in interest rates in recent months – and renewed confidence both domestically and abroad about Canada's economic future – is relatively new and still fragile. These hard-won gains must be maintained. Fiscal actions that have already been set in train will reduce the deficit in 1998-99 to about 1 per cent of GDP, but implementation must be assured. This budget provides that assurance by staying the course on deficit reduction.

The government has focused its fiscal efforts on achieving and bettering its deficit targets – a necessary step to addressing Canada's debt problem. Even though the debt-to-GDP ratio is projected to decline in 1997-98, however, it will still amount to nearly 75 per cent of Canada's GDP and exceed 100 per cent when provincial governments' debts are included. Federal debt servicing costs already account for one-third of every dollar raised in revenues (Chart 3.8). Such a debt financing burden diverts revenues from programs and investments that Canadians want and need. In short, the crux of Canada's fiscal problem has been, and remains, the high debt-to-GDP ratio.

The combined debt of all governments in Canada is second only to Italy in the G-7, in relative terms, and is well above that of our major trading partners. Although less exposed than a few years ago, Canada is still vulnerable to unexpected financial market developments. International capital markets are closely integrated and events such as the Mexican peso crisis in 1995 clearly show that financial market volatility is greatest in economies with weak fiscal situations.

The debt-to-GDP ratio is poised for a significant and sustained decline, but from a high level. The government will need to ensure that projected fiscal gains are realized and are lasting and that the debt-to-GDP ratio is reduced to a more manageable level.

Chart 3.8*Interest on the federal debt as a per cent of budgetary revenues*

The challenge for the future is thus to maintain sufficient operating surpluses to keep the debt-to-GDP ratio on a steady downward track. The operating surplus is forecast to increase to close to 5 per cent of GDP by 1998-99. For illustrative purposes, if this surplus was maintained for five years, then the debt-to-GDP ratio would fall to 62 per cent – back to its 1991-92 level. A steady reduction in the debt-to-GDP ratio will require careful financial management for some time to come.

The fiscal strategy must – and will – stay on track. Careful financial management means that now is not the time for a broadly based tax cut. Under the prudent economic planning assumptions on which the budget is based, a broadly based tax cut would have to be paid for in one of two ways – by adding to the deficit, or cutting government programs even further. Adding to the deficit is not an option – it would only serve to increase interest rates and diminish the prospects for jobs and growth that are now emerging. Cutting spending further would put at risk programs that Canadians want preserved.

Economic growth could turn out to be stronger and interest rates lower than assumed in the budget. But Canada's new-found economic and fiscal credibility is too recent to risk on an overly optimistic view of Canada's economic prospects. To do so would risk all the fiscal gains that have been made to date.

However, there is limited room for strategic reinvestments. This budget announces investments and selective tax cuts in critical areas to enhance jobs and growth, or to invest in a stronger society. The deficit is clearly on track to meet future targets, even with the selected initiatives announced in this budget.

An Impressive Turnaround by International Standards

International fiscal comparisons are made difficult by different accounting conventions used in various countries. Fiscal data based on the System of National Accounts, provided by the Organization for Economic Co-operation and Development (OECD), present a common basis for international fiscal comparisons and analysis.

Based on OECD data, Canada's total government sector deficit is projected to improve sharply relative to other G-7 countries.¹

- In 1992, the combined federal and provincial deficit on a national accounts basis stood at 7.4 per cent of GDP, almost double the G-7 average of 3.8 per cent and second highest in the G-7 behind Italy.²
- In 1997, Canada's total government deficit is forecast to be the lowest among G-7 countries, at 1.3 per cent of GDP. In 1998, Canada's deficit-to-GDP ratio is expected to be roughly in balance, again the best performance in the G-7 countries.
- In addition, Canada's total government debt-to-GDP ratio fell in 1996 for the first time since 1988. The decline in the Canadian debt-to-GDP ratio between 1997 and 1998 will be the largest of the G-7 countries.

¹ OECD *Economic Outlook*, December 1996.

² The total government deficit-to-GDP ratio on a national accounts basis was 7.4 per cent in 1992, corresponding to a public accounts ratio of 9.6 per cent (see Annex 3 for more details).

Detailed Overview of the Fiscal Outlook to 1998-99

Changes from the 1996 budget forecast for 1996-97 and 1997-98

Chapter 2 provided an update of the economic developments in the past year and the prospects for 1997. Table 3.5 outlines the impact of these changes, as well as the effect of the policy initiatives announced since the last budget and other factors, on the deficit targets for 1996-97 and 1997-98.

Nominal income – the applicable tax base for budgetary revenues – is expected to be lower than assumed in the 1996 budget for both 1996 and 1997. As a result, all major components of budgetary revenues, with the exception of corporate income tax collections, are expected to be lower than assumed in the 1996 budget. On balance, the effect of the economic developments is expected to lower budgetary revenues by \$2.0 billion in 1996-97 and \$2.8 billion in 1997-98.

However, program spending is expected to be \$0.8 billion lower for both 1996-97 and 1997-98 than estimated in the 1996 budget. Data available to date indicate that benefit payments for both seniors and employment insurance will come in below the estimated values in the 1996 budget and this is expected to carry forward into 1997-98. Transfers to other levels of governments have been revised downward, primarily due to lower Equalization transfers. Lower provincial revenue growth, reflecting tax reductions in some provinces and the strength of resource sector revenues in some Equalization-receiving provinces have lowered the formula-based entitlements. Other spending has been adjusted up to reflect reprofiles from previous years and the reclassification of revenues from the air transport tax, which are no longer netted against program spending.

In addition, the decline in interest rates witnessed during 1996 has resulted in much lower-than-expected public debt charges. Short-term rates in 1996 were 160 basis points on average lower than those assumed for planning purposes in the 1996 budget, while long-term rates averaged 50 basis points lower. Although rates are assumed to rise in 1997 from current levels, mainly due to the prudence factors built into these rates for planning purposes, they are still expected to be below the levels projected in the 1996 budget.

As a result, public debt charges are expected to be \$2.3 billion lower in 1996-97 and \$3.0 billion lower in 1997-98 than assumed in the 1996 budget.

The net impact of these economic developments is to lower the deficit by about \$1 billion per year in both 1996-97 and 1997-98.

Table 3.5

The fiscal outlook – changes since 1996 budget

	1996-97	1997-98
	(billions of dollars)	
1996 budget deficit track	24.3	17.0
Impact of economic factors		
Revenues:		
Personal income tax	0.2	0.5
Corporate income tax	-0.7	-0.1
Sales and excise taxes	1.3	1.3
Employment insurance premiums	0.2	0.0
Other revenues	1.0	1.1
Total	2.0	2.8
Program spending:		
Major transfers to persons	-1.0	-1.3
Major transfers to other levels of government	-0.4	-0.8
Other spending	0.6	1.3
Total	-0.8	-0.8
Public debt charges	-2.3	-3.0
Net impact of economic factors	-1.1	-1.0
Impact of one-time factors		
Sale of air navigation system	-1.5	
EI premium acceleration	-1.0	
Total	-2.5	
Contingency Reserve	-2.5	
Net impact of policy changes since 1996 budget	0.8	1.0
Net changes since 1996 budget	-5.3	0.0
1997 budget deficit track	19.0	17.0

Note: (-) indicates a reduction in the deficit, (+) indicates an increase in the deficit.

There were two notable one-time factors that lowered the 1996-97 deficit by \$2.5 billion. Net proceeds from the sale of the air navigation system amounted to \$1.5 billion. In addition, as part of the reform of the employment insurance program, premiums, effective January 1, 1997, are based on hours worked rather than on number of weeks worked. This results in an acceleration of premium revenues from the latter half of the calendar year to the first half for higher-income employees and their employers. Although this has no effect on employee/employer EI liability for the calendar year as a whole, the acceleration of premiums does result in a one-time gain on a fiscal year basis. Neither of these initiatives were included in the 1996 budget estimate for 1996-97, given the uncertainty of the timing of the sale and of the estimates of the impact of the EI change.

The financial results to the end of December 1996 clearly indicate that the deficit for 1996-97 will be lower than the target of \$24.3 billion and that the Contingency Reserve will not be required. The Contingency Reserve has been removed for 1996-97, thereby lowering the deficit accordingly. The reserve remains at \$3.0 billion for 1997-98.

Finally, the net fiscal impact of the initiatives undertaken since the 1996 budget, including the measures proposed in this budget, amount to \$0.8 billion in 1996-97 and just under \$1.0 billion in 1997-98.

As a result of these developments, the deficit for 1996-97 is expected to be no greater than \$19.0 billion, while the deficit target for 1997-98 remains clearly on track.

The Revenue Outlook

The revenue outlook to 1998-99 is summarized in Table 3.6.

Based on the financial results for the first nine months of 1996-97, budgetary revenues are now estimated at \$135.5 billion – up \$5.2 billion or 4.0 per cent from 1995-96. About half of this increase is attributable to one-time factors: the sale of Transport Canada's air navigation assets to NavCan – a private non-profit corporation – and the change in the timing of EI premiums. Excluding the impact of these factors, the revenue-to-GDP ratio is virtually unchanged from 1995-96.

Table 3.6
The revenue outlook

	1994-95	1995-96	1996-97	1997-98	1998-99
(billions of dollars)					
Personal income tax	56.3	60.2	63.3	66.5	70.4
Corporate income tax	11.6	16.0	15.8	16.2	17.1
Employment insurance contributions	18.9	18.5	19.6	19.3	19.7
Excise taxes and duties					
Goods and services tax	16.8	16.4	16.9	17.5	18.4
Customs import duties	3.6	3.0	2.3	2.1	1.9
Other excise taxes	6.7	7.3	7.8	8.1	8.3
Other tax revenues	1.8	2.1	2.1	2.1	2.0
Total tax revenues	115.7	123.3	127.8	131.7	137.7
Non-tax revenues	7.6	7.0	7.7	6.1	6.3
Total budgetary revenues	123.3	130.3	135.5	137.8	144.0
Per cent of GDP	16.5	16.8	17.0	16.5	16.6

Numbers may not add due to rounding.

These special factors also dampen the overall growth rate of revenues between 1996-97 and 1997-98. For 1997-98, budgetary revenues are expected to increase by only 1.7 per cent. Excluding the impact of these factors, the gain is 3.5 per cent. In 1998-99, budgetary revenues are expected to increase more in line with the growth in the economy.

Personal income tax – the single largest source of federal revenue – is expected to increase \$3.1 billion, or 5.2 per cent, in 1996-97. This mainly reflects developments relating to the 1995 taxation year: higher payments on filing, higher payments relating to arrears and higher quarterly instalment payments. These revenue sources reflect to a large extent economic developments in 1995. During 1996-97, taxfilers were required to remit larger quarterly instalments on income not subject to withholding. This represents an acceleration of payments from 1997-98 to 1996-97, which could result in lower taxes paid on filing in 1997-98. Withholdings from employment income advanced at a slower pace during the year, broadly in line with employment and wage growth. In both 1997-98 and 1998-99, personal income tax collections are expected

to grow slightly faster than the economy, due to the progressivity of the tax system, with higher marginal tax rates at higher levels of taxable income. In addition, with inflation expected to be well within the target range, there will be no indexation of the personal income tax parameters.

Corporate income tax revenues are expected to decline slightly in 1996-97 to \$15.8 billion. Over the first nine months of 1996-97, corporate income tax revenues increased 12.6 per cent from the same period a year earlier. This growth is a reflection of the remittance procedures for large corporations as corporate profits are expected to be unchanged from 1995. Corporations are required to file monthly instalments on either last year's tax liability or the current year's estimated liability. Corporations have 60 days after their year end to file, with any amounts outstanding due at that time. As a result, over 30 per cent of corporate income tax collections are received in the months of February and March – the settlement period. In 1995-96, settlement payments were very strong reflecting relatively low instalments during the year. As corporate profits are expected to be little changed from last year, settlement payments are not expected to show the same strength as last year. Corporate income tax revenues are expected to pick up in both 1997-98 and 1998-99, as corporate profit growth resumes. The surtax on the capital of banks and other large deposit-taking institutions, first introduced in the 1995 budget, is being extended for one more year.

The increase in EI premiums in 1996-97 primarily reflects the changes to the base on which premiums are levied, from weekly maximum insurable earnings to annual maximum insurable earnings. The impact of this is a one-time increase in receipts from EI premiums in the January-to-March period of 1996-97. This change does not affect the annual amount paid. Those earning up to annual maximum insurable earnings will see no change in their annual contributions, while those earning more than annual maximum insurable earnings will pay more of their contributions earlier in the year. Premium contributions are expected to decline slightly in 1997-98, as the impact of lower premium rates (the employee rate fell by five cents in 1997), coupled with the costs of the New Hires Program offsets the effects of increases in employment. For planning purposes, the employee rate is assumed to decline by 10 cents in 1998.

Goods and services tax revenues are expected to grow broadly in line with growth in final consumer demand over the forecast period. Customs import duties are expected to continue to decline over the forecast period, as the effect of tariff reductions under the various trade agreements more than offsets the growth in imports. The increase in other excise taxes reflects the impact of the increase in taxes on tobacco products announced in November 1996.

Non-tax revenues include return on investments, most notably Bank of Canada profits and Exchange Fund earnings, and other non-tax revenues, such as user fees and charges. The large increase in 1996-97 is due to the proceeds from the sale of Transport Canada's air navigation assets.

Outlook for Program Spending

Table 3.7 provides the major elements of program spending through to 1998-99.

By 1998-99, program spending will have declined for six consecutive years, falling from its peak of \$122.6 billion in 1992-93 to \$103.5 billion in 1998-99. As a share of GDP, program spending is projected to decline to 11.9 per cent by 1998-99, the lowest ratio since 1949-50. This decline primarily reflects the impact of the restraint measures introduced in each of the last three budgets. All major components of program spending contribute to this absolute decline in total program spending, with the exception of major transfers to persons.

Major transfers to persons consist of seniors' benefits, including old age security, the guaranteed income supplement, spouses' allowances and employment insurance benefits. The increases in seniors' benefits reflect growth in the seniors' population and increases in maximum benefits, which are indexed to changes in the consumer price index. The proposed Seniors Benefit is scheduled to come into effect in 2001. Reforms to the EI system, coupled with growth in employment, have significantly restrained the growth in benefits. From a peak of \$19.1 billion in 1992-93, benefits are expected to fall to \$13.1 billion in 1996-97. Over the next two years, benefit payments are expected to rise, even as the economy improves, since the number of beneficiaries relative to the number of unemployed typically increases during economic upturns.

Table 3.7

The outlook for program spending

	1994-95	1995-96	1996-97	1997-98	1998-99
(billions of dollars)					
Major transfers to persons					
Elderly benefits	20.5	21.0	21.6	22.3	22.9
Employment insurance	14.8	13.5	13.1	13.5	14.1
Total	35.3	34.5	34.7	35.8	37.0
Major cash transfers to other levels of government					
CHST ¹	19.3	18.6	14.9	12.5	11.8
Equalization	8.5	8.8	8.5	8.3	8.4
Transfers to territories	1.2	1.2	1.1	1.1	1.1
Other fiscal transfers	-0.4	-0.2	0.1	0.0	0.0
Alternative Payments for Standing Programs	-1.8	-1.9	-2.0	-2.1	-2.2
Total	26.7	26.5	22.6	19.8	19.1
Subsidies and other transfers					
Business subsidies	3.7	2.3	2.3	1.8	1.5
Indian and Inuit	3.7	4.1	4.3	4.4	4.4
International assistance	2.9	2.2	2.2	2.1	1.9
Science and technology	1.0	0.9	1.7	0.9	0.8
Canada Infrastructure					
Works	0.4	0.9	0.5	0.6	0.0
Other	8.3	7.8	7.3	6.8	5.9
Total	20.0	18.2	18.3	16.5	14.5
Crown corporations	5.0	4.3	4.3	3.9	3.8
Defence	10.7	9.9	9.6	9.0	8.5
Other	21.0	18.6	19.5	20.8	20.7
Total	118.7	112.0	109.0	105.8	103.5

Numbers may not add due to rounding.

¹ Through to 1995-96 includes Established Programs Financing (EPF) and Canada Assistance Plan (CAP). Beginning in 1996-97, refers to the Canada Health and Social Transfer (CHST). Entitlements under the EPF/CAP and CHST are as follows:

29.3	29.6	26.9	25.1	25.1
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Total entitlements (both tax and cash) for major transfer to other levels of government (CHST, Equalization and transfers to the territories) are as follows.

38.2	38.7	35.7	33.6	33.7
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Cash transfers to other levels of government are projected to fall from \$26.7 billion in 1994-95 to \$19.1 billion by 1998-99. This decline is largely due to reductions in entitlements through to

1997-98 under the CHST – the block-funded transfer introduced in the February 1995 budget, which has replaced transfers under the Established Programs Financing (EPF) and the Canada Assistance Plan (CAP). Like EPF, the CHST entitlement takes the form of tax point transfers and cash transfers. A tax point transfer involves the transfer of federal “tax room” to provinces, which allows the provinces to raise their tax rates by an equivalent amount, with no impact on taxpayers. The cash transfer is the difference between the entitlement and the value of the tax point transfer. Only the cash transfer affects program spending. In the 1995 budget, total entitlements were set at \$26.9 billion for 1996-97 and \$25.1 billion for 1997-98. The 1996 budget legislated a five-year CHST funding arrangement, covering the years 1998-99 to 2002-03. For 1998-99 and 1999-2000, CHST entitlements will be maintained at their 1997-98 level of \$25.1 billion. For 2000-01 to 2002-03, entitlements will grow at an increasing pace – 2 per cent less than the growth rate of GDP in 2000-01, 1.5 per cent less in 2001-02, and 1 per cent less than the growth rate of GDP in 2002-03. In addition, the legislation provides a guarantee that, over this five-year period, cash transfers will never fall below \$11 billion.

Another key transfer to provinces is Equalization. Lower provincial revenue growth, due primarily to tax reductions in some provinces, the strength of resource revenues in some of the Equalization-receiving provinces and population changes between Equalization-receiving and non-Equalization-receiving provinces have significantly restrained the growth in the formula-based entitlements. Transfers to the territories are also expected to remain flat over the 1994-95 to 1998-99 period.

The Alternative Payments for Standing Programs represent recoveries of federal tax point abatements under the contracting-out arrangements. Under these arrangements, any province could assume the administrative and financial authority for certain federal-provincial programs. Under such arrangements, the federal government would reduce the federal personal income tax rates in that province, so that province could increase its rate by an equivalent amount. The value of these additional tax points under contracting-out arrangements are recovered from the cash transfers. Quebec was the only province to choose these arrangements when they were offered in the mid-1960s. The recoveries have no impact on net federal transfers or on Quebec’s net receipts.

The reduction in subsidies and other transfer payments between 1994-95 and 1998-99 reflects the impact of the restraint measures introduced in each of the last three budgets.

- Business subsidies are expected to decline by sharply reflecting substantial reductions in transportation subsidies (the elimination of the *Western Grain Transportation Act* payments and other railway subsidies), agricultural subsidies and funding to the regional agencies.
- Funding for international assistance is budgeted to decline by \$1 billion.
- Grants in respect of science and technology – direct grants made by the National Research Council and university research granting councils – will be relatively unchanged over the forecast period.
- The rate of growth in transfers under the Indian and Inuit programs (Department of Indian and Northern Affairs and the aboriginal health programs administrated by Health Canada) is being restrained.
- Within the remaining component, reductions have been made to labour market and cultural programs, while veterans' allowances and pensions are expected to be relatively stable.

The measures announced in the last three budgets will also result in significantly lower Crown corporation expenditures, as well as on defence.

All other spending includes departmental operating costs and centrally held funds to assist departments in managing unavoidable cost pressures arising during the fiscal year.

- The 1994, 1995 and 1996 budgets introduced measures that significantly reduced the operating costs of departments. The wage freeze was extended to 1996-97. Certain government activities were privatized or commercialized. The actions taken will result in the elimination of about 55,000 positions from the federal public service, once they are fully implemented.
- In the 1995 budget, the government introduced the Expenditure Management System, to ensure that departmental spending would be strictly controlled on an ongoing basis.

Public Debt Charges

Public debt charges represent the largest component of total federal government spending, representing about 30 per cent of total spending. Nearly one-third of each revenue dollar goes to paying interest on the public debt.

The significant decline in interest rates in 1996 halted the dramatic rise in public debt charges over the last few years. They are expected to be no higher than \$45.5 billion in 1996-97, down \$1.4 billion from 1995-96 (Table 3.8). Over the next two years, public debt charges are expected to increase somewhat, as higher new borrowings offset the decline in average effective interest rate on the debt. By 1998-99, the government is not expected to borrow any new funds from the market. Interest rates declined significantly throughout 1995 and 1996 and although some increase from current levels is assumed for planning purposes over the forecast period, the average effective interest rate on government debt should continue to decline as instruments are refinanced at the lower rates.

Table 3.8
Public debt charges

	1994-95	1995-96	1996-97	1997-98	1998-99
(billions of dollars)					
Public debt charges	42.0	46.9	45.5	46.0	46.5

As noted in Annex 3, the high stock of debt makes the fiscal situation extremely sensitive to changes in interest rates. As the debt has grown, so has the importance and complexity of managing that debt effectively. The objective of the government's debt management strategy is to raise funds at stable and low costs. One key element of this strategy has been to reduce the share of debt held in short-term floating rate instruments. By doing so, the government has significantly reduced its exposure to unexpected changes in interest rates. Further information on the government's debt management strategy are contained in Annex 3 and in the *Debt Operations Report*, Department of Finance, November 1996.

Financial Requirements

Financial requirements provide a measure of net new borrowing required in credit markets – that is, borrowing over and above that needed to replace maturing debt issues. Financial requirements are projected to be eliminated by 1998-99 (Table 3.9).

Table 3.9
Deficit, non-budgetary transactions, and financial requirements/source

	1994-95	1995-96	1996-97	1997-98	1998-99
(billions of dollars)					
Deficit	-37.5	-28.6	-19.0	-17.0	-9.0
Non-budgetary transactions					
Loans, investments and advances	-0.1	2.7	1.1	0.9	1.0
Specified purpose accounts	8.7	7.6	7.7	8.0	8.5
Other transactions	3.0	1.1	4.3	2.1	0.6
Total non-budgetary transactions	11.6	11.4	13.0	11.0	10.0
Financial requirements/ source	-25.8	-17.2	-6.0	-6.0	1.0

Numbers may not add due to rounding.

-) implies a requirement for funds/(+) implies a source of funds.

The difference between financial requirements and the deficit is due to a number of non-budgetary transactions that provide funds to the government. The largest of these is the government's employees' pension accounts. Other smaller sources of funds include loans, investments and advances, cash in transit and accounts payable.

Non-budgetary transactions also include accounting adjustments to certain transactions that are reported on an accrual basis to reflect the impact of these on a cash basis. One important adjustment is for restructuring charges. Although restructuring charges adversely affect the deficit in the year in which the liability is incurred, they only affect financial requirements when payments are actually made.

Non-budgetary transactions are estimated at \$13.0 billion in 1996-97, up \$1.6 billion from 1995-96. The 1996-97 results are affected by extraordinary receipts made during the course of the year. Final instalment payments relating to the 1995 sale of CNR

and shares in Petro-Canada will result in the receipt of about \$2 billion in 1996-97. Under the government's accounting practices, the deficit impact of these sales was recorded in 1995-96, when the sales occurred. These final payments, therefore, had no effect on the 1996-97 deficit but did provide additional cash during the year. The net source of funds is expected to decline in both 1997-98 and 1998-99, primarily reflecting developments in "other transactions", relating to the lower amortization adjustments in an environment of a falling stock of short-term debt and the fact that no extraordinary receipts are expected in those years.

Financial requirements are expected to be no higher than \$6 billion in 1996-97, a decline of \$11.2 billion from 1995-96, of which \$9.6 billion is attributable to the decline in the deficit, with the remainder due to the higher net funds resulting from non-budgetary transactions. Financial requirements are expected to be unchanged in 1997-98, despite the decline in the deficit, given the lower net funds from non-budgetary transactions. However, in 1998-99, there is expected to be a net financial source of \$1 billion. This means that the government will not be going to the market for new borrowings – only to refinance the existing stock of debt. In fact, with a financial source, the government will be repaying part of the existing debt.

Borrowing Authority

The amount of borrowing authority requested from Parliament for a fiscal year has traditionally been tied to financial requirements for that year, adjusted for estimated Exchange Fund earnings. Borrowing authority to cover Exchange Fund earnings is sought because these earnings, although reported as part of budgetary revenues, remain in the Exchange Fund Account and are not available to finance the ongoing operations of government. In addition, a non-lapsing amount of \$4 billion is requested, which can either be used during the course of the year to manage contingencies, such as unexpected foreign exchange requirements, or be carried forward temporarily into the next fiscal year. Any borrowing authority remaining above that amount at the end of the fiscal year lapses.

The government will be introducing legislation seeking appropriate borrowing authority, consisting of financial requirements of no more than \$6 billion, expected Exchange Fund earnings of \$0.8 billion and \$4 billion of non-lapsing authority.

Jobs and Growth in a Dynamic Economy¹

Introduction

Many Canadians are anxious about the job market and their place in it:

- While the unemployment rate has fallen over the past three years, it still remains unacceptably high.
- Many currently employed workers worry that they could lose their jobs and have difficulty finding new ones.
- Some people have given up looking for jobs while others have been forced to take part-time work when they want full-time jobs.
- Many workers are seeing their wages grow only slowly, if at all.
- Parents are worried that their children will not be able to find good jobs.

The government shares these concerns and has made creating more and better jobs for Canadians its top economic priority. The government's strategy is based on the recognition that there are two types of problems that must be addressed:

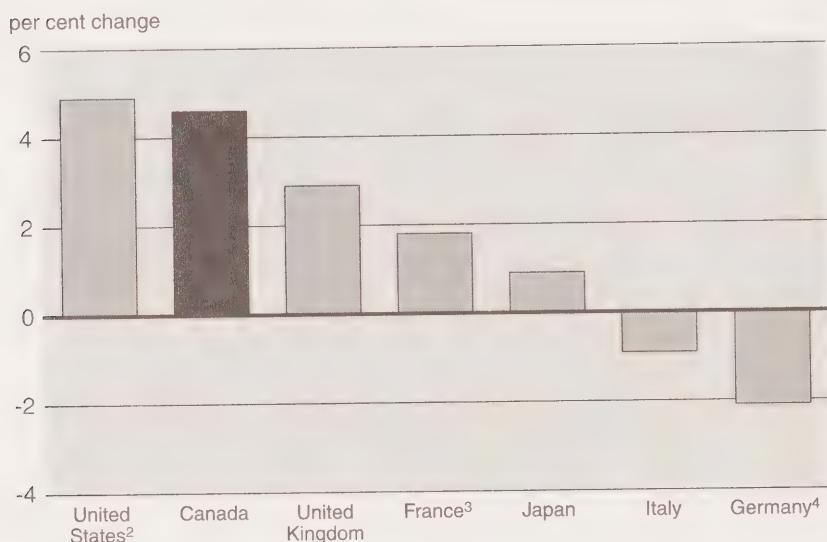
- First, the pace of economic growth has not been sufficient to generate enough new jobs, particularly at a time when the public sector has been contracting.
- Second, some individuals and businesses need help adapting to the profound economic changes that are occurring due to globalization and technological change.

¹ All statistical references as of Wednesday, February 12, 1997.

All the industrial world has been buffeted by the dramatic changes in the economic environment of recent years. And many countries have recently been forced to confront the consequences of their past inattention to fiscal responsibility. As a result, many industrial economies have seen disappointing job growth. Although no one should be satisfied with the pace of job creation in Canada, the fact is that employment growth in Canada has been faster than in any other Group of Seven (G-7) country except the U.S. since the fourth quarter of 1993 (Chart 4.1).

Chart 4.1

Growth in employment¹ in G-7 countries from the fourth quarter of 1993 to the third quarter of 1996



¹ Employment series may not be strictly comparable among countries because of differences in definitions. Comparisons of per cent changes, rather than level changes, are therefore more reliable.

² Household Employment Survey.

³ Employment in all sectors except agriculture, public administration, education and social services. The sub-sector comprises around two-thirds of total civilian employment.

⁴ Not seasonally adjusted.

Most industrial countries face similar challenges. In responding to these challenges, the government has been pursuing a four-pronged strategy for jobs and growth in a stronger society:

- Staying the fiscal course to create the right economic environment for strong and sustained job creation.

- Promoting job creation in the short- and medium-term through programs that have both immediate and lasting benefits.
- Making strategic investments that will strengthen job creation in the long term by helping Canadians undertake the higher education, training and innovation needed to make the most of the opportunities provided by globalization and technological change.
- Building a stronger society by making investments that promote the health and well-being of Canadians.

The previous chapter explained how the government is staying the fiscal course. This chapter details the government's investments in immediate jobs and growth, and its investments in long-term job creation and growth. The next chapter details the government's investments in a stronger society.

Providing the Right Economic Environment

The key to generating faster employment growth in the short- and medium-term is to determine why employment growth has often been slow in recent years, and to fix those problems. The chain of causation reaches all the way back to the massive level of debt that this government inherited when it took office.

Developments in 1994 illustrate the problem well. Canadian interest rates began to rise in 1994, driven initially by events outside Canada – the increase in U.S. interest rates that began early in 1994 and then the Mexican peso crisis that began late in 1994. Both events dramatically affected Canadian interest rates because Canada lacked credibility with investors, both foreign and domestic. Investors were concerned about:

- the ability of all levels of government in Canada to meet their financial commitments as they piled up debt – at a rate well in excess of the growth of the economy – by running high deficits;
- whether Canada would remain committed to keeping inflation low; and
- the rapid growth in Canada's foreign debt, driven by massive government borrowing, record interest payments to foreigners, and years of importing more than the economy exported.

Investors' lack of confidence in Canada could be seen in the recommendations of many investment advisors to avoid Canadian assets, and in the fact that Canadian interest rates were well above

U.S. interest rates despite Canada's consistently superior inflation performance since the beginning of 1992.

The jumps in interest rates in early 1994 and again in early 1995 hit the Canadian economy just as it was shifting into higher gear. High interest rates discouraged consumers from spending and businesses from investing, which in turn discouraged firms from hiring, which only further discouraged consumers.

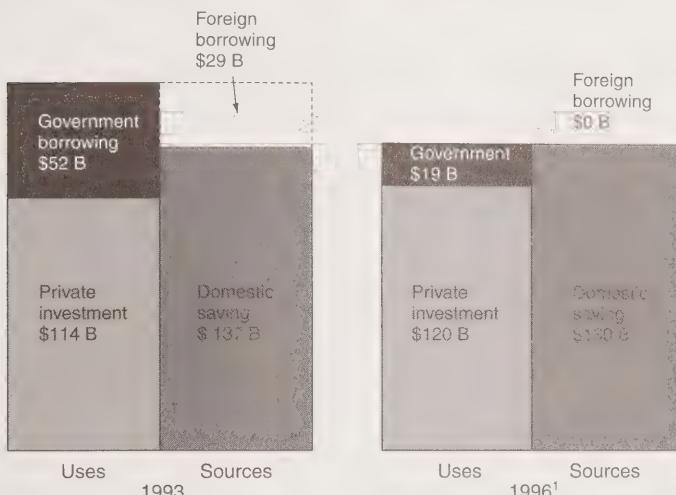
This period of high interest rates is now past. Canada's federal, provincial and territorial governments have made determined efforts to cut their fiscal deficits, bringing about the dramatic improvement in Canada's fiscal situation detailed in Chapter 3.

As well, Canada's commitment to low inflation has been reaffirmed and adhered to. Since the government and the Bank of Canada jointly extended the inflation control targets in late 1993, the core inflation rate (consumer price inflation excluding food, energy and the effect of indirect taxes) has been well within the target range of 1 to 3 per cent. Consumer price inflation over that period has been at its lowest sustained level in three decades, and less than one-quarter of the average inflation rate during the 1980s.

Fiscal responsibility and continued low inflation have led to a sharp turnaround in investor confidence. Investment advisors who had been counselling their clients to avoid Canadian assets in 1994 have since been enthusiastically recommending Canada. The result has been a dramatic downward trend in interest rates since early 1995, albeit temporarily interrupted by the uncertainty stemming from the Quebec referendum in the autumn of 1995.

Short-term interest rates are now at their lowest levels in close to 35 years, and more than 200 basis points below comparable U.S. rates. This is the first sustained period in more than 20 years that Canadian short-term rates have been below U.S. rates. Indeed, interest rate spreads vis-à-vis key U.S. rates have shrunk across the maturity spectrum and Canadian rates are now lower than those in the U.S. on maturities of up to 10 years.

Moreover, reduced government borrowing and improvements in Canada's international competitiveness have led to a dramatic reduction in borrowing from abroad (Chart 4.2). That has made it possible for interest rates to fall without causing a sharp drop in the Canadian dollar.

Chart 4.2*Sources and uses of saving: 1993 and 1996*

¹ First three quarters of the year at annual rates.

Because it takes some time before a change in interest rates exerts its full effect on economic growth and job creation, the Canadian economy has yet to enjoy the full positive effect of the reductions in interest rates that began in 1995. However, some of the impact is already clearly evident. As discussed in Chapter 2, resales of existing houses have reached their highest level in more than 15 years, helping to boost housing starts to their highest level in two years. In the fourth quarter of 1996, new motor vehicle sales reached their highest level in more than five years. And business investment jumped over 20 per cent at an annual rate in the third quarter of 1996.

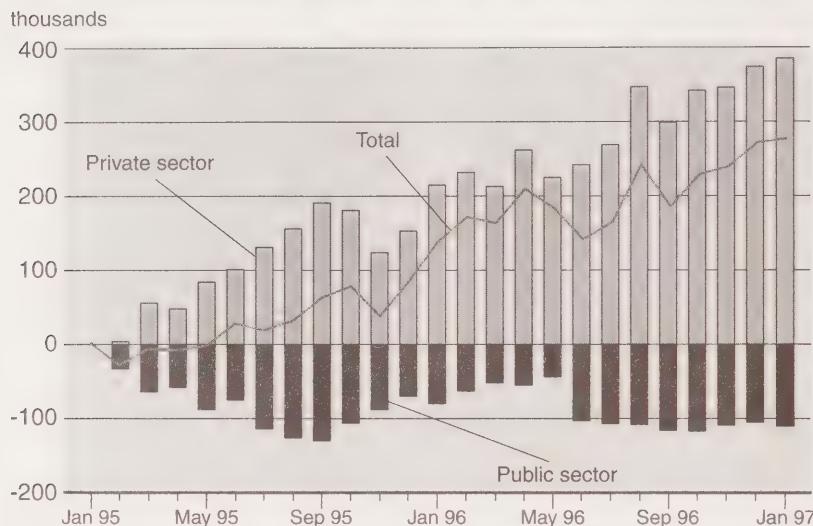
These positive developments have led to the creation of 231,000 net new jobs in the private sector since the end of 1995. The expected improvement in job growth in 1997 will generate income gains and further improve consumer and business confidence which will further stimulate economic expansion and job creation.

It must be recognized that government spending cuts themselves have tended to restrain economic and job growth in the short run. However, many more jobs have been created in the private sector than have disappeared in the public sector (Chart 4.3). Many of those new private sector jobs would not exist without the reduction in interest rates made possible by the government's fiscal efforts.

The interest rate declines since 1995 will support further job creation in the private sector in 1997 and 1998.

Chart 4.3

Cumulative employment growth since January 1995 by sector



Canada's Economic Challenge

Healthy economic conditions can only go part of the way towards reducing unemployment and improving labour market conditions in the long run. Individuals and firms who have been unable to adjust to the profound changes that are taking place in the world economy have seen the value of their skills and assets deteriorate, resulting in unemployment, underemployment and declining incomes. In the words of the Organization for Economic Co-operation and Development (OECD) Jobs Study, in the long run,

“... the single most important cause of rising unemployment, as well as a growing incidence of low-wage jobs, is the growing gap between the need for OECD economies to adapt and to innovate and their capacity, and even their will, to do so.”²

Individuals and firms must seize on the opportunities that arise from globalization and technological change. Here government also has an important role to play: to encourage innovation, and to design policies that help workers and firms adapt to and take advantage of these new opportunities.

² OECD, *Jobs Study: Facts, Analysis, Strategies*, June 1994, p. 41.

Globalization

Declines in the costs of communications and transportation and the need for increased expenditures on research and development have led many businesses to produce for and from a global market rather than a national one. The end result has been a significant restructuring of business activity towards greater specialization. Firms that have moved quickly towards globalization have typically reduced their costs of production, quickly expanded markets, and enjoyed rapid growth in output and employment.

Canada has been well placed to take advantage of globalization. Canada has long been one of the most trade-oriented of the major industrialized countries, with well-developed and expanding links with firms around the world, particularly in the world's richest market, the U.S.

Over the past three years, Canada has benefited substantially from the increased movement of goods, services, R&D and investment around the world. The volume of Canada's exports has increased by 50 per cent since 1992. During that period, export growth has been the largest single contributor to Canada's economic growth and job creation (see Chart 4.4).

Chart 4.4

Employment by trade orientation

index, 1993:1 = 1.00

1.20

1.15

Export-oriented
industries

1.10

1.05

1.00

0.95

Non-export-oriented
industries

1993

1994

1995

1996

However, restructuring by firms and increased import penetration have also had profound effects on those Canadian businesses and workers who have had difficulties adjusting. While OECD analyses suggest that the negative impacts are small relative to the job gains in skilled work created by globalization, one of the roles of government is to ensure that some of the economy's gains from globalization are used to help those who are having difficulty adapting so they too can benefit.

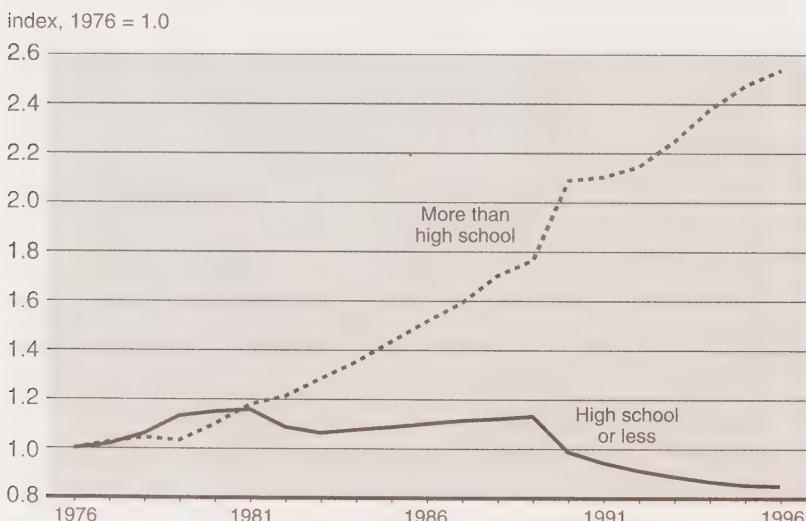
Technological change

The need to adapt to globalization is deeply intertwined with pervasive technological change, especially as new information technologies have appeared. All industries can benefit from technological improvements, not only those that are commonly regarded as "high-tech".

Technological change has created additional demand for high-skilled workers throughout the economy. At the same time, it has slowed the demand for lower-skilled workers. This shift in demand is evident in the trend decline in employment of individuals with less than high school education, in contrast to continued steady employment growth for those with some post-secondary education (Chart 4.5).

Chart 4.5

Employment by level of education



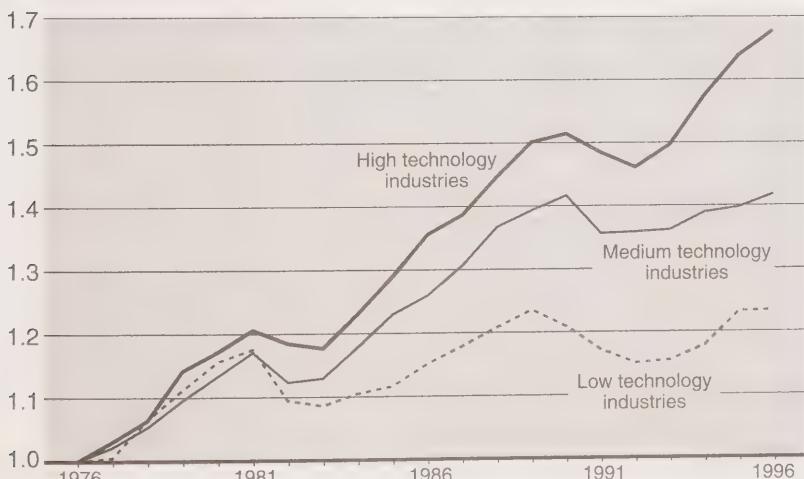
For every low-education job lost over the past two decades, about 15 higher-education jobs have been created. As Chart 4.5 demonstrates, this divergent pattern has been underway since 1981, but accelerated in the 1990s.

Technological progress has been accompanied not only by higher output and productivity, but also by higher overall employment. While technological progress has increased productivity and output in all sectors of economic activity, in traditional as well as non-traditional industries, its positive effects on employment have been particularly evident in those industries that rely more intensively on high technology. Over the last 20 years, employment in Canadian industries that use high technology inputs intensively grew more than twice as fast as employment in low technology industries and 60 per cent faster than employment in medium technology industries (Chart 4.6). Similarly, wages tend to be higher, and grow faster, in plants that use more advanced technologies.

Chart 4.6

Employment¹ by level of input technology

index, 1976 = 1.0



¹ Business-sector employment.

Industries are classified by measuring the high tech proportion of their non-labour inputs.

Improvements in technology enable a myriad of new products, new services and higher incomes. To fully enjoy those benefits, businesses must be prepared to develop and adopt new products and techniques, and workers must be prepared to upgrade their skills.

Youth employment

Technological change is increasing the advantage that young people can gain from higher education. As a result, young people are staying in school longer. However, just as technological change has increased the value of education, it has also increased the value of on-the-job experience. This has made it particularly difficult for young people, who increasingly lack work experience, to find and keep permanent jobs.

This has created a vicious circle: lacking work experience, young people find it difficult to obtain stable employment, which keeps them from gaining work experience even as the premium placed on that experience is rising.

Investing in Immediate Jobs and Growth

The economic conditions favourable to healthy private sector job creation are now in place. However, low interest rates have only begun to translate into stronger economic growth and job creation.

Thus while the foundations for robust job creation are in place, far too many Canadians remain unemployed. To help bridge the gap to stronger growth, the government is helping the private sector to create jobs in the near term through programs that will also leave lasting benefits.

Canada Infrastructure Works

Three years ago, the federal government committed \$2 billion, in partnership with provincial and municipal governments, to launch a \$6 billion program to renew and enhance Canada's infrastructure while supporting employment in 12,000 construction projects across Canada.

The government recently extended the Canada Infrastructure Works program by allocating an additional \$425 million to that program in 1997-98, bringing its total funding to \$600 million in that year. This funding, together with provincial and municipal contributions, will help support a total of \$1.8 billion in infrastructure projects across the country in 1997-98.

In meeting Canada's infrastructure needs, it will be important to apply the virtues of partnership and innovation. Innovative public-private partnership financing arrangements – including the “BOOT” (build, own, operate, transfer) concept recommended by the Standing Committee on Transport – offer potential advantages in terms of more efficient and lower cost delivery of infrastructure services in some situations, and warrant serious examination and encouragement at all levels of government in Canada.

Residential Rehabilitation Assistance Program

The federal government recently announced that it has allocated \$50 million to extend the Residential Rehabilitation Assistance Program (RRAP) and related housing programs for one year. These measures support home renovation for low-income Canadians, allow seniors to adapt their homes, and aid victims of family violence by upgrading transition shelters. Half of the \$50 million cost will be funded by internal reallocation within the Canada Mortgage and Housing Corporation.

EI premium reductions and New Hires Program

Improved labour market conditions and employment insurance (EI) reforms have allowed EI premiums to come down in recent years and will allow them to come down further in the future. The reduction in the EI premium rate in 1997 was the third successive decrease in as many years. The EI premium rate for workers has been reduced from \$3.07 in 1994 to \$2.90 in 1997, and the rate for employers reduced from \$4.30 to \$4.06 in the same period. Further, the annual maximum insurable earnings have been rolled back to \$39,000 in 1996 and frozen at that level, providing further premium relief.

The New Hires Program announced in November 1996 will provide employment insurance premium relief to small firms that create new jobs in 1997 and 1998. By reducing the cost of new workers, this program will encourage small firms to accelerate their job creation plans while the stimulative effect of lower interest rates continues to build. Legislation to implement this program will be introduced shortly.

The New Hires Program builds on the transitional premium relief program included in EI reform, increasing the relief from \$150 million to \$465 million over two years for firms which had paid EI premiums of less than \$60,000 in 1996. Depending on the wages their employees earn, this means that firms with up to about 100 full-time employees could be eligible – a total of about 900,000 businesses. Under the program, eligible employers will pay virtually no premiums for new jobs created in 1997, and will benefit from a 25-per-cent reduction for new jobs created in 1998.

The New Hires Program, combined with recent premium reductions and other EI changes, will save employers and workers about \$1.7 billion in 1997 relative to what they would have paid without these changes. This brings the cumulative savings from EI premium reductions and other changes since 1994 to \$4 billion.

Facilitating the transition from school to work

While unemployment is of concern to all Canadians, young people often find it particularly difficult to find that critical first job that bridges the gap between school and work. This, in turn, hinders their ability to develop on-the-job skills which are becoming increasingly important to employers.

To help young Canadians bridge the gap between school and work, the Minister of Human Resources Development recently announced the details of a \$255 million Youth Employment Strategy covering the next two years. Funds for this strategy were provided in the 1996 budget. The strategy will support 120,000 summer career placements over 1997-98 and 1998-99 as well as the creation of new internship programs in partnership with the private sector, volunteer organizations and government agencies. There are three components to the internships: science and technology, international, and aboriginal youth, both on Indian reserves and in Inuit communities. These internships will provide 19,300 young Canadians over two years with real work experience.

Existing youth programming (Youth Internship Canada and Youth Services Canada) will be refocused on “at risk” youth who face barriers to full labour market participation, including limited education, problems with the law, disabilities and single teenage parenthood. The exact nature of these program changes will be determined in consultation with the provinces and territories.

The government will reallocate resources to expand the national youth volunteer service, Katimavik, and place it under the responsibility of the Minister of Canadian Heritage. Katimavik invests in the lasting personal development of hundreds of participants, increasing their knowledge of Canada and contributing to mutual understanding among young Canadians.

Tourism

The tourism sector has a proven track record of creating jobs in all regions of the country. Canada's travel account deficit with the rest of the world has declined by more than 50 per cent, from \$6.4 billion in 1992 to \$3.0 billion in 1995. The co-ordinated efforts of the partners of the Canadian Tourism Commission (CTC) contributed to this impressive improvement.

When the CTC was created in 1995, the federal government tripled its funding for tourism promotion from \$15 million to \$50 million per year. The CTC has also attracted about 1,400 partners who are expected to contribute over \$65 million this year. This surpasses the \$50 million challenge issued following the creation of the CTC.

Incremental funds for the Canadian Tourism Commission

This budget proposes that the Canadian Tourism Commission's budget be increased by \$15 million a year over the next three years. Most of these incremental funds will be used for promotion in foreign markets to ensure that Canada's tourism potential is fully realized over the coming years. As in the past, partners in the private sector will be asked to match this federal contribution dollar for dollar.

Equity injection for Business Development Bank

The government is also creating a new tourism financing vehicle to be administered by the Business Development Bank of Canada (BDC), and financed through a \$50 million equity injection involving the purchase of dividend-paying preferred shares. The vehicle will operate on a commercial basis and will make possible some \$250 million in new BDC loans for expansions or upgrades of mid-range tourism facilities outside major urban centres. Partnerships with private sector financial institutions could bring the total incremental financing available for tourism investments to \$500 million.

Visitor's Rebate Program

With the introduction of the Goods and Services Tax (GST), the Visitors' Rebate Program was established to minimize the impact of the GST on the tourism industry. Rebates are available to non-residents of Canada on short-term accommodation, certain goods exported from Canada and other goods and services used in the course of a convention. The program both encourages exports and promotes Canada as an attractive destination for vacations, trade shows and conventions.

The government is proposing a review of the Visitors' Rebate Program to determine whether the current design and administration can be improved to target resources more effectively to promote Canada as a tourist destination and support the tourism industry in the creation of employment.

Rural Canada

Nearly one-quarter of all Canadians live in rural Canada and they, like other Canadians, are experiencing the challenge of economic adjustment. This budget looks to the future, to helping Canadians in rural Canada to take advantage of new opportunities, particularly the substantial scope which exists for economic diversification.

Farm Credit Corporation

Consistent with the commitment to rural Canada in the 1996 Speech from the Throne, this budget will take steps to promote opportunities for growth and diversification in rural Canada in a manner which is tailored to the unique needs of rural Canadians. As part of this, the budget will provide the Farm Credit Corporation (FCC) with \$50 million in additional capital. Consideration will be given to the development of new equity instruments as potential financial tools to augment existing loan programs for farmers. The government will also continue to seek creative approaches to ensure that its Crown financial agencies work better together to promote the economic development of rural Canada, particularly the agri-business sector. The government will also pursue opportunities for more partnerships, syndications, joint ventures and other means of co-operation and risk-sharing with private sector financial institutions and/or Crown financial corporations to improve the range of appropriate financial products and services available in rural Canada.

Community Access Program

The rapid changes which are taking place in information technology present new opportunities for learning, interaction and economic development. Business and local development possibilities are becoming less dependent on location and more on access to information technologies.

Industry Canada's Community Access Program is playing an important role in linking Canadian communities to the information highway. The last budget provided funding to assist the process of linking 1,500 rural, remote or disadvantaged communities.

In this budget a further \$30 million will be made available over the next three years to expand the interconnection of rural Canadian communities. This expansion could lead to the interconnection of some 5,000 communities to the Internet – virtually all communities between 400 and 50,000 in population. The government will also work with community leaders to develop multiple access points within communities so that individuals, businesses and voluntary groups are connected to each other as well as to other communities. These initiatives will complement the government's Computers for Schools Program, which aims to provide 100,000 computers to schools across Canada by the year 2000.

Support for small businesses

Small- and medium-sized businesses (SMEs) are a critical source of employment growth. However, small firms may have difficulties in accessing international markets, or in adopting and developing new technologies. To help SMEs overcome those obstacles, the federal government provides assistance to that sector through a variety of programs including the *Small Business Loans Act*, the Business Development Bank of Canada, the Canada Community Investment Plan, Canada Business Services Centres, and a number of provisions in the tax system, as well as the recently announced New Hires Program.

Reducing the regulatory burden

Since 1994, the federal government has worked closely with the business community to find ways to reduce the regulatory burden on small businesses through the Joint Forum to Reduce Paper Burden on Small Business. The government heard that, for many small businesses, the monthly remittance of withholding amounts

from their employees' pay, which include income tax, employment insurance premiums and Canada Pension Plan contributions, imposes a significant burden because they do not have the in-house resources that larger businesses have. The Joint Forum recommended reducing the frequency of remittances for small businesses.

The government is accepting their recommendation. In order to reduce the burden arising from the remittance of withholding amounts, the budget proposes allowing employers with average monthly remittances of less than \$1,000 to remit on a quarterly basis. Participation would be optional and only those with perfect compliance records over the preceding 12-month period would be eligible. Perfect compliance records for both withholdings and GST remittances will be required. Quarterly remittances would reduce the time spent by small businesses on the administration of payroll deductions. As many as 650,000 small businesses could benefit from this measure.

Moving to quarterly remittances for small businesses would have a one-time impact on the deficit of \$180 million in 1997-98 because withholding amounts for January and February 1998 would not be remitted to the government until April, the beginning of the 1998-99 fiscal year. There would also be ongoing annual costs of \$5 million.

Small Business Loans Act

The *Small Business Loans Act* (SBLA) assists new and existing small businesses to obtain term loans from chartered banks and other lenders to finance the purchase and improvement of fixed assets. Since 1995, the SBLA has been operating on a cost recovery basis. This budget proposes that the ceiling for this program be raised from \$12 billion to \$14 billion.

Encouraging LSVCCs to invest in small business

Labour-sponsored venture capital corporations (LSVCCs) are funds sponsored by labour organizations to help improve access to capital for SMEs. Federal and provincial tax credits have helped LSVCCs accumulate over \$3 billion in assets. This has enabled LSVCCs to help many SMEs create and maintain jobs. Nevertheless, some smaller businesses continue to have difficulty finding the equity financing they need to expand and create jobs.

The budget proposes changes to LSVCC rules to encourage LSVCCs to invest more actively in smaller businesses, thereby helping them create jobs. Information on these and other changes of a more technical nature related to LSVCCs is included in the supplementary notes.

Facilitating international trade

Export-oriented industries have seen the healthiest rate of job creation in recent years. To not only preserve but further exploit this key source of growth and job creation, the government supports exporters in a variety of ways: pursuing trade liberalization through multilateral and bilateral trade agreements, implementing measures to assist companies develop and expand their export business, and bolstering awareness of Canada's advantages as a location for investment.

Team Canada trade missions

A key expression of the government's focus on trade is the Team Canada trade missions. The demonstration of interest provided by the presence of Canada's government leaders on the Team Canada missions gives Canadian business leaders unparalleled access to their counterparts in the host countries. Canadian businesses have announced 549 business arrangements worth an estimated \$22 billion during the various Team Canada missions since 1994. These announcements include contracts and agreements in principle (such as memoranda of understanding and joint ventures). As a result of this success, more Team Canada missions are planned for the future.

Innovative sources of export financing

Access to competitive export financing often determines whether a firm can win export contracts. The government is working with the Export Development Corporation (EDC) and commercial lenders to develop innovative means for institutional and retail investors in capital markets to participate in the financing of exports through securitization. Securitization involves the packaging of export finance loans into marketable investment grade securities. It is a vehicle which can help expand and diversify the sources of financing available to Canadian exporters. It is envisaged that the government could provide up to \$20 million in capital to facilitate this initiative.

Simplified Customs Tariff

For businesses in Canada to compete effectively, they need access to inputs at the lowest possible cost. The government is helping to ensure this. To date, action by this government has resulted in customs tariff reductions for businesses and consumers estimated to be worth approximately \$600 million in 1996.

A process to simplify the tariff system and ensure it is responsive to the competitive pressures facing Canadian businesses was launched in the 1994 budget and has included detailed study of a wide range of issues and extensive consultations with all interested parties on various proposals. One set of measures, which reduced tariffs on a broad range of manufacturing inputs, was implemented in June 1995. The resulting decline in the cost of producing in Canada has already helped businesses improve their competitive position in the marketplace.

New legislation will be tabled shortly to introduce a new simplified *Customs Tariff* to come into effect on January 1, 1998, coinciding with the full implementation of tariff elimination under the Canada-U.S. Free Trade Agreement. The new simplified Tariff will continue to improve the competitiveness of Canadian manufacturers by providing industry with a less costly, more predictable and more transparent tariff environment for making production and investment decisions.

International financial market stability

The success of Canadian firms doing business abroad also depends on the existence of well-functioning international financial markets. To help maintain the stability of the international financial system, Canada must stand ready to participate in international efforts to manage systemic shocks should they occur. Amendments will be proposed to the *Bretton Woods and Related Agreements Act* to facilitate the government's participation in internationally co-ordinated bridge loans which address such situations.

Pursuing sustainable development

Canada's abundant natural resources are a significant source of employment and well-being for many Canadians, especially those in regions far removed from urban communities. It is important that the development and use of these resources be carried out in a sustainable manner to ensure long-term economic security, while respecting Canada's environmental endowment.

Movement towards the integration of economic and environmental goals is fundamental to ensuring the continued prosperity of Canadians and to safeguarding Canada's natural heritage for future generations. The government has sought opportunities to integrate economic and environmental policy decision-making involving various government departments. The government is proceeding with a number of initiatives that are consistent with this objective and that are part of its ongoing work of removing barriers and disincentives to sound environmental practices.

Steady progress has been made through previous budgets to advance environmental objectives through conservation and protection measures dealing with mine reclamation trusts, donations of ecologically sensitive lands, energy efficiency and renewable energy. This budget proposes further steps which build on this progress and the government's ongoing commitment to sustainable development.

Environmental trusts and ecologically sensitive land

As a measure to enhance the protection of Canada's natural heritage, this budget proposes improvements to the income tax treatment of contributions to environmental trusts. The existing rules providing for deductions for contributions to mine reclamation trusts will be extended to the waste disposal and aggregates sectors. This budget also proposes a new method of valuation to encourage donations of easements and covenants of ecologically sensitive land. By encouraging the protection of ecologically sensitive land, this measure will build on the government's broader commitment made through such key pieces of environmental legislation as the *Canada Endangered Species Protection Act*. Annex 6 provides further details on these initiatives.

Incentives to invest in renewable energy and energy conservation

The 1996 budget announced several measures to improve access to financing for the renewable energy and energy conservation sector and to create a more level playing field between renewable and non-renewable energy investments. The most important initiative was the creation of Canadian Renewable and Conservation Expenses (CRCEs), a new category of fully deductible expenses. This new category for renewable energy investments provides a more comparable income tax treatment with that provided to oil and gas exploration and development expenses since all new CRCE costs can be renounced using flow-through share (FTS) agreements.

In December 1996, detailed descriptions of this new category were released. Based on stakeholder consultations following the release of these draft regulations, this budget proposes additional modifications to improve these provisions and thereby build on the 1996 budget commitment to create a level playing field for renewable energy investments. The details of these modifications are provided in Annex 6.

Energy efficiency investments

The 1996 budget highlighted the importance of energy efficiency investments. In order to identify impediments to such investments, consultations were held on the treatment of energy efficiency investments and investments providing heating and cooling from renewable energy sources. One impediment identified by stakeholders is a lack of information and awareness about the economic and environmental benefits of technologies and practices to improve energy efficiency. Accordingly, attention is drawn to the considerable progress that has been made in the development of recognized standards for buildings and houses (National Energy Code for Buildings and the National Energy Code for Houses) and in the design and testing of the Canadian Home Energy Efficiency Rating System. These codes represent Canada's first comprehensive energy efficiency standards.

A number of representations were also received suggesting that the tax system be used to provide an incentive for energy efficient buildings. Proposals were varied in nature with some focusing on those new commercial buildings meeting very high energy efficiency standards, while others suggested incentives to encourage energy efficient retrofits of the existing building stock. Still other suggestions were received supporting a greater use of renewable energy to meet the energy needs of buildings. Several proponents suggested that any new tax incentives should not be technology-specific but instead be tied to overall performance criteria such as embodied in the new National Energy Codes for Buildings and Houses. These codes will be published in final form in the next several months.

The government is prepared to examine the appropriateness of using some tax or other mechanism to promote energy efficiency investments linked to the National Energy Code for Buildings. To this end, the government will be examining various alternatives and will set aside \$20 million per year for three years beginning in 1998 to promote investments in both energy efficiency and renewable energy for new and existing commercial buildings.

Infrastructure

The extended Canada Infrastructure Works program will continue to contribute to job creation and help meet local priorities such as the renewal of physical infrastructure, including water and sewage treatment plants. A continuing objective of this program is to enhance the quality of the environment and contribute to environmental sustainability.

Other measures that affect jobs and growth

The government is seeking to ensure that all its programs contribute the maximum possible to job creation and skills development while serving other needs.

Aboriginal economic development

The development of opportunities benefiting aboriginal communities represents a particularly important challenge. There has been some significant increase in recent years in activity of this type: financial institutions have become increasingly active in aboriginal communities; the First Nations Bank of Canada was established in December 1996 and the community-owned Aboriginal Capital Corporations have become a major source of funding for aboriginal-owned small businesses. While progress has been impressive, much remains to be done.

One suggestion that has been put forward is the extension of tax credits to investors in aboriginal venture capital corporations. Further discussion with aboriginal organizations will be undertaken on this idea.

Aboriginal governments may also wish to generate funds to support economic and social development in their communities.

The government has indicated its commitment to discussing with First Nations their interests, aspirations and concerns with respect to taxation. To further this process, the government is expressing its willingness to put into effect taxation arrangements with First Nations that indicate an interest in exercising taxation powers. Clearly, the initiative for such arrangements will rest with individual First Nations.

Prior to reaching such agreements, the government and interested First Nations will have to deal with a number of potentially difficult issues, such as the co-ordination of taxes and the special

position of potential taxpayers who are not members of the First Nations. These issues are discussed in the draft *A Working Paper on Indian Government Taxation* released by the Department of Finance in 1993.

Broadcasting initiatives

Canada's cultural industries are not only an important expression of Canadian sovereignty, they are important employers. The \$200 million Canadian Television and Cable Production Fund launched last September will not only enhance Canadian content on television, it will also support job creation and skills development in Canadian broadcasting.

An additional \$10 million per year has been allocated directly to the Canadian Broadcasting Corporation's (CBC) radio networks, recognizing the unique voice they provide and the fact that they have not benefited from the Production Fund.

The government is also committing to a stable five-year financial framework for the CBC; the annual appropriation will not fall below the level currently planned for 1998-99.

Transfer pricing

Transfer pricing refers to the pricing of transactions undertaken by parties that do not deal at arm's length and that are situated in different countries. Since transfer prices affect the profits and, thus, the income tax base of taxpayers who are members of multinational groups, the *Income Tax Act* includes rules that ensure that transfer prices are consistent with prices that would have been charged on similar transactions among parties dealing with each other at arm's length. A number of developments have affected transfer pricing rules in other countries as well as international principles set out by the Organization for Economic Co-operation and Development, on which Canadian practices are based.

As a result of these developments, the government will be updating its current practices in the area of transfer pricing. In particular, new documentation requirements will be introduced, together with new penalty provisions, to ensure taxpayer compliance and facilitate administration by Revenue Canada. Moreover, additional resources will be committed towards administration and enforcement of the new rules in order to ensure their effective application and protect the Canadian tax base.

Investing in Long-Term Job Creation and Growth

Meeting the economic challenge posed by globalization and technological change also requires investments that will pay off in the long run. To neglect the long term in favour of the present would be short-sighted policy. Instead, the government is continuing to expand its long-term strategic investments in Canada's technological capability and in higher education and skills training.

Investing in higher education and skills

The new and better-paying jobs that are the result of innovation and economic restructuring require increasing levels of skill among the workforce. Without a qualified workforce, it is hard to create or use the latest in technology. As a result, attaining higher levels of education and skills is critical to the ability of Canadians to secure their own and Canada's future. But at the same time, the costs of higher education, including both tuition fees and other related costs, are rising.

The 1996 budget provided an \$80 million increase in direct federal tax assistance for higher education. The amount on which the education credit is based was increased from \$80 to \$100 per month; the limit on the transfer of tuition and education amounts from students to parents was raised from \$4,000 to \$5,000 per year; the annual limit on registered education savings plan (RESP) contributions was increased from \$1,500 to \$2,000, and the lifetime limit for RESP contributions was increased from \$31,500 to \$42,000.

This budget proposes a substantial further enrichment of federal assistance provided to higher education and skills enhancement. The budget provides additional resources to help students and their families better cope with the rising costs of education, to help workers to enhance their skills, to help students facing higher debt loads after graduation, and to encourage parents to save for their children's education. The proposed measures will increase federal support in this area by \$137 million in 1998-99, growing to \$202 million in 1999-2000, and to about \$275 million annually when the measures are mature.

Additional tax assistance to students

To help students enrolled in post-secondary education, the budget proposes the following measures:

- The amount used to establish the education credit will increase to \$150 per month immediately, and to \$200 per month for 1998 and subsequent years.
- As tuition fees rise, the amount of assistance provided by the tuition fee credit increases automatically. However, students also have to pay a number of ancillary fees. The budget proposes to extend the tuition tax credit to cover mandatory ancillary fees imposed by universities to cover the cost of education. This extension will not apply to fees levied by student bodies for non-educational purposes.
- Students or their parents may not have enough tax payable in a given year to benefit fully from the tuition and education credits. To ensure that all students can use these credits fully, students will now be allowed to carry forward all unused portions of these credits, to be applied against any future tax liability. This measure will also benefit workers who are returning to school.

As a result of these budget measures, by 1998 a student in full-time attendance at a post-secondary institution for eight months, will be able to claim an education amount of \$1,600. Such a student also facing tuition fees of \$2,800 and ancillary fees of \$300, will thus receive over \$1,200 in tax assistance per year. This total reflects a federal credit rate of 17 per cent and a combined federal and provincial credit rate of about 26 per cent. Therefore, total tax assistance will increase by more than 30 per cent from the \$900 in assistance available to this student in 1995.

Helping students to repay their loans

Through the Canada Student Loans Program, the federal government provides financial assistance to students who need help to pursue post-secondary education. Provinces deliver both the Canada Student Loans Program and their own complementary programs.

Students are expected to start repaying their Canada Student Loans six months after graduation. Some students may face difficulties because they cannot find work quickly or, for other reasons, do not have sufficient income to meet their payments. For this reason, students facing hardship are allowed to defer making payments on their loans for up to 18 months. The federal government pays interest accruing on the student's loan during this period.

This provides considerable help but, as a post-secondary education coalition recently pointed out, it still leaves some students unable to meet their obligations. To better recognize students' capacity to repay their loans, the federal government, in response, will extend to 30 months the period of time that students will be permitted to defer making payments. The government will pay the interest that the students would have paid over this extended period. Combined with the initial six months after graduation when no payments are required, this means that students will have up to three years of help in dealing with their loans.

This measure will be effective August 1, 1997. It is projected that it will provide an additional \$20 million a year in assistance to students.

In addition, the federal government is ready to pursue with interested provinces, lenders and other groups an additional option for repaying student loans. Students would be able to choose between the current type of repayment arrangements and a repayment schedule tied directly to the individual's income. The individual would be expected to repay the whole of the loan over time, without any interest relief or subsidy during the repayment period.

Enhancement of registered education savings plans (RESPs)

This budget also proposes measures that will help parents save for their children's education:

- Annual contribution limits to RESPs will be doubled to \$4,000. This will assist parents who are not able to start saving for their children's education when they are young, and therefore have fewer years to make contributions. It will also provide major incentives for increased savings for education.
- Under current RESP provisions, all RESP income must go for educational purposes, so that the family loses the investment income in their plan if their child does not pursue higher education. Since this can discourage parents from starting an RESP, two measures are proposed to address this problem. First, individuals winding up an RESP will now be allowed to transfer all or part of their RESP income into their registered retirement savings plan (RRSP), provided they have unused RRSP room. Alternatively, individuals without available RRSP room, or who do not wish to make RRSP contributions, will be allowed to receive the investment income directly, subject to an appropriate charge. This charge will ensure

that assistance is not provided for those who might use RESPs for tax-deferral purposes unrelated to either education or retirement savings.

Helping Canadians enhance their skills

The vast majority of people who will be in the Canadian workforce in the year 2005 have passed through the education system and are already in the labour force. Given the rapid pace of technological change, many of these workers will need further education and skills upgrading. In many cases, the best way for them to acquire the necessary skills will be through on-the-job training.

Because the chances to find, get and keep jobs are directly related to levels of literacy, the government will increase support for literacy activities, especially in the workplace, by increasing the budget of the National Literacy Secretariat from \$22.3 million to \$29.3 million commencing in 1997-98, a 31 per cent increase.

This increased support will assist Canadians in their transition to the new knowledge-based economy by building a strong foundation of basic literacy and communications skills. By improving individuals' literacy skills, it will increase their access to learning opportunities. Increased literacy for all Canadians is at the heart of the lifelong learning needed for individuals and organizations to adapt in the changing global economy.

Special priority will be placed on fostering literacy in the workplace and in the family. The 1995 International Adult Literacy Survey demonstrated that the strength of individuals' literacy skills at home and on the job is key to full participation in the nation's economic, social and cultural life. These two priorities complement the commitment of the government last fall to provide a full rebate of the GST on books to educational institutions, public libraries, municipalities and qualifying charities and non-profit organizations which promote literacy.

Employment insurance reform is an important part of the government's jobs and growth strategy. EI reform focuses on helping people get back to work as quickly as possible by reinvesting \$800 million in savings in a results-oriented set of employment benefits. It also reinforces the value of work by providing a better match between the amount of earnings from work and the benefits received.

Led by the Minister of Human Resources Development, the federal government is working closely with provinces and territories to provide integrated active employment measures to better enable Canadians to prepare for, find and keep jobs. The government is prepared to negotiate agreements with all provinces and territories to enable them to respond more effectively to local conditions in providing results-oriented measures to assist EI clients to get back to work. These measures could include wage subsidies, earnings supplements, self-employment assistance, job creation partnerships, and skills loans and grants.

Agreements have already been signed with Alberta and New Brunswick. Negotiations with the remaining provinces and territories are continuing. Provinces and territories will have access to almost \$2 billion for active employment measures. These active measures will provide up to 400,000 unemployed Canadians with additional help to prepare for, find and keep jobs.

Investing in innovation

The future economic prosperity of Canadians, as well as health and environmental quality of life, will increasingly depend on innovation – on the generation of new knowledge and the ability to put it into productive use.

Innovation is critical to creating the leading edge technologies on which future growth and job creation depend. It is important not only to the emergence of new high technology industry sectors, but also to the future growth and competitiveness of many of Canada's more traditional industry sectors. Investing in Canada's capacity to innovate is therefore an important component of the government's strategy for creating the conditions for long-term job creation and economic growth.

The ability to innovate successfully in the future will increasingly depend on individuals with the knowledge to create new ideas. It also requires individuals who can understand new technologies and put them into effective use in the form of new products and new processes.

Canada's post-secondary educational institutions and research institutions are an integral part of the "root system" which feeds the country's knowledge base. They provide scientists and researchers who are engaged in developing new ideas and new technologies. They also generate the trained graduates who will be

expected to meet the demands of a more technologically oriented marketplace. Excellence in higher education for Canadian young people and global competitiveness for Canadian companies go hand in hand.

Canada Foundation for Innovation

The ability of Canadians to carry out leading edge research and technology development will depend not only on their research skills, but also on increasingly sophisticated infrastructure. However, the research facilities at many Canadian universities and research hospitals have not been keeping pace with the demands of world-class research and higher education, and require new investment.

Modernizing research infrastructure will help to encourage young researchers to pursue their careers in Canada. It will help to produce graduates who understand and can apply developments in science and technology. Integrated systems of research and research infrastructure among universities, research hospitals and the private sector also help to attract skills and investment, and generate local economic activity.

In this budget, the government is therefore proposing to create the Canada Foundation for Innovation. The purpose of the Foundation will be to provide financial support for the modernization of research infrastructure at Canadian universities and colleges, in research hospitals, and in associated not-for-profit research institutions and organizations in the areas of health, environment, science and engineering.

- The Foundation represents an entirely new approach by the government to the support of research and development. It will be an independent corporation at arm's length from government and drawn primarily from members of the research community and the private sector. They, not the government, will be responsible for assessing projects and making spending decisions.
- The Foundation will be funded by an up-front investment by the federal government of \$800 million, which will allow the Foundation to provide about \$180 million annually over five years.

Σ The success of the Foundation will depend on the willingness of Canadians to take on the challenge of enhancing Canada's research infrastructure through partnerships – among post-secondary educational institutions and research hospitals, the business community, the voluntary sector, individuals and, to the extent they wish to participate, provincial governments. Through partnerships, the Foundation has the potential to trigger about \$2 billion in investment in research infrastructure.

- The Foundation will not support projects of government departments, agencies or Crown corporations.

Networks of Centres of Excellence

Successful innovation increasingly involves the development of partnerships between the research community and companies seeking to develop new technologies. The Networks of Centres of Excellence (NCEs), which link researchers in various locations across the country in areas as diverse as robotics, genetic diseases and pulp and paper, have been a superb means of capitalizing on the advantages of collaboration.

To help expand these vital research partnerships, the government is renewing this program with a commitment of \$47 million annually, funded through a combination of existing resources and reallocation of \$19 million from Industry Canada and the Granting Councils.

Industrial Research Assistance Program

The Industrial Research Assistance Program (IRAP), which promotes the diffusion of technology, is a valuable national program for small businesses. The government will maintain IRAP funding at the current level of \$96.5 million per year funded through a combination of existing resources and \$13 million to be reallocated from within the Industry Canada portfolio.

Table 4.1
Investing in jobs and growth since the 1996 budget

	1996-97	1997-98	1998-99	1999-2000
(millions of dollars)				
Investing in immediate jobs and growth				
Measures announced prior to the 1997 budget				
Canada Infrastructure Works	425			
Extension of RRAP ¹	50			
New Hires Program	250	65		
CBC radio	10	10		10
Subtotal	735	75		10
Measures proposed in the 1997 budget ²				
Canadian Tourism Commission	15	15		15
Community Access Program	10	10		10
Quarterly remittances for small business	180	5		5
Environmental initiatives	–	25		25
Revenue Canada costs for transfer pricing initiative	8	10		12
Subtotal	213	65		67
Investing in long-term job creation and growth				
Investing in higher education and skills				
Increase education credit	5	45		80
Extend tuition credit to ancillary fees	5	30		30
Carry-forward of unused tuition and education credits		10		25
Student loan interest relief	20	20		20
RESP ³ measures	10	25		40
National Literacy Secretariat	7	7		7
Subtotal	47	137		202
Investing in innovation				
Canada Foundation for Innovation	800			
Networks of Centres of Excellence		18		19
IRAP ⁴		13		13
Subtotal	800	31		32
Total	800	995	308	311

¹ Residential Rehabilitation Assistance Program.

² Equity injections in Business Development Bank of Canada and Farm Credit Corporation are non-budgetary.

³ Registered Education Savings Plans.

⁴ Industrial Research Assistance Program.

– Less than \$5 million.

Building the Future: Investing in a Stronger Society

Introduction

Canadians recognize that good economic policy is good social policy. Reducing the deficit and controlling the debt burden are essential if programs that support the well-being of Canadians are to be sustained. Strong and sustained economic growth is vital to the creation of well-paying jobs and a prosperity that is widely shared among Canadians. Well-functioning markets, proper incentives and the removal of barriers to labour market participation are essential if all Canadians are to be able to participate fully in the growing economy. And good social policy is, as well, a key ingredient of a strong economy.

Good programs are those that are affordable, sustainable and meet Canadians' needs. They should give Canadians the tools and opportunities to share in Canada's prosperity.

The government's last three budgets took important steps in this direction. These included the new employment insurance program, the reform of federal transfers to provinces in support of health care, post-secondary education and social assistance, and the proposed new Seniors Benefit. Also included were measures to assist families and the most vulnerable in Canada.

Building a strong society also demands partnerships – among governments and with various groups in society. The shared focus of federal and provincial governments on efficient and effective programs has opened the door for increased federal-provincial

co-operation in a wide variety of areas. This budget continues this process – especially in the approach to improving support to children in low-income families. The government is also committed to strong partnerships with non-profit and voluntary organizations that provide much-needed services to enhance the quality of life for Canadians.

The challenges confronting Canadian society and communities in the face of rapid change demand that Canada become more aware of the economic contribution and potential of the social sector. Social needs are met not merely through income support. They are also met through services delivered in the social economy by people such as caregivers, social workers and volunteers. In the process, jobs and opportunities for skills development are generated. Government can play its part by supporting these important social activities as resources permit. The measures in this budget are a significant contribution in this regard. Charities, non-profit organizations, co-operatives and other community-based organizations must be front and centre in this effort to enhance Canada's well-being through a collective initiative.

This budget invests in a stronger society through initiatives that:

- improve Canada's health care system;
- increase support for children in low-income families by moving forward with the provinces to design an integrated child benefit system;
- enhance support for persons with disabilities; and
- increase the ability of charitable organizations in Canada to finance their activities.

This chapter also lays out the actions being taken by the government to ensure a sustainable retirement income system.

Sustaining and Improving Canada's Health Care System

Canadians want their publicly funded health care system preserved because they know it has served them and their families well. Canadians expect their governments to uphold universal access to health care, yet are concerned that recent developments may impede accessibility and affect the quality of care. The federal government remains unequivocally committed to the principles underlying

medicare and to ensuring that Canada's publicly funded health care system is maintained. Provincial health ministers recently released a report in which they reaffirmed their commitment to maintain and protect the integrity of Canada's national health system and the principles of medicare.

At the same time, the federal government is well aware that changes are needed. It has already taken some important steps to facilitate changes that will strengthen medicare:

- The 1996 budget allocated \$65 million to launch a new Health Services Research Fund which funds practical research on the delivery and the quality of care provided to Canadians.
- Under legislation enacted last year, the provinces are provided with predictable and assured funding under the new Canada Health and Social Transfer (CHST). CHST entitlements will be maintained at a stable level of over \$25 billion, and then grow at a rate linked to the growth of the economy. A floor provision guarantees that the cash portion of the transfer will never be less than \$11 billion through the period of the current legislated arrangement. The federal government also provides over \$8 billion in Equalization payments to seven provinces which can be used to support provincial services such as health care.
- In addition, the government has fulfilled a number of commitments in health, including the Centres of Excellence for Women's Health, the Aboriginal Head Start Program and the Canada Prenatal Nutrition Program, and has moved ahead in critical areas such as new and more effective tobacco legislation and steps to enhance the safety of the blood system.

The National Forum on Health

The National Forum on Health was created by the Prime Minister to develop a vision of the health system that will meet the health needs of Canadians into the 21st century. In its recent report, the Forum concludes that Canada's health care system is fundamentally sound and adequately funded, but that there is ample evidence that resources could be used more effectively and efficiently.

It calls for funds to be made available for a limited period to aid in the transition to new and better ways of meeting Canadians' health needs, including ways of ensuring that doctors and other caregivers have the best possible information readily available to

them when they make decisions on how to treat patients. In their recent report on health, provincial health ministers also called for measures to support evidence-based decision-making.

The National Forum on Health emphasizes that the health of Canadians depends on many factors outside the health care system. In its words, “there is more to health than health care”. For example, the Forum calls attention to the harm caused by deprivation during early childhood.

This budget responds to these calls. The government will allocate \$300 million over the next three years to additional health initiatives.

Health Transition Fund

The federal government will provide \$150 million over the next three years for a Health Transition Fund to help provinces launch pilot projects to investigate new and better approaches to health care. Projects could include, for example, better ways to provide medically necessary drugs and home care services. These funds will be allocated to provinces and territories on an equal-per-capita basis, with decisions regarding expenditures to be made jointly by Canada’s ministers of health.

Canada Health Information System

Providers of medical care should have access to the best medical information, including the latest developments regarding medical treatments. The government has allocated \$50 million over the next three years to put in place a new Canada Health Information System.

The Community Action Program for Children and the Canada Prenatal Nutrition Program

The Community Action Program for Children and the Canada Prenatal Nutrition Program are two existing federal programs that help prevent health problems from developing. The Community Action Program for Children funds community groups that deliver services to address the developmental needs of young children who are at risk. Services include infant stimulation, parent/family resource centres, child development centres and parenting education. The Canada Prenatal Nutrition Program addresses the

problem of low birth weight babies among high risk groups such as pregnant adolescents and women who abuse alcohol and drugs. The government will increase funding for these programs by \$100 million over the next three years. The Minister of Health will consult his provincial colleagues in setting priorities.

Towards a National Child Benefit System

Too many Canadian children who are growing up in low-income families are not getting the start they need to become healthy, happy, educated and productive adults who can contribute to tomorrow's society.

Problems with the current Child Benefit System

Through the federal Child Tax Benefit and provincial and territorial programs, governments provide substantial support to low-income families with children. But there is a growing consensus that governments can do more, and do better.

Some families on social assistance are better off than families where parents work in low-paying jobs. For example, parents who leave welfare to enter the workforce lose child allowances under social assistance (which can be \$3,000 or more for a two-child family) as well as access to benefits such as subsidized drugs and dental care. Families must also pay a range of taxes they would otherwise not have to pay. This loss is only partially offset by the Working Income Supplement (WIS) under the Child Tax Benefit and provincial measures that assist low-income working families.

The drop in services and support encountered by parents who leave social assistance for a job is unfair. It creates a barrier that keeps families on welfare. Parents should not be put in the position of having to penalize their children in order to take a job. By working together to reform child benefits, governments can create a fairer system and take an important step in combating child poverty.

Federal-provincial-territorial review of child benefits

At their meeting in June 1996, first ministers identified investment in children as a national priority. Since then, the federal, provincial and territorial governments have been working together to find ways of improving the assistance provided to children in low-income families.

Different methods of doing so have been examined. A single uniform benefit would be the simplest and least expensive to administer. On the other hand, benefits that vary by province can better reflect regional differences in wages and prices, fiscal capacities and in design objectives. Variation also favours innovation in design and delivery.

Based on these considerations, the National Child Benefit System should have two parts: a federal foundation for all eligible Canadian families – to be called the Canada Child Tax Benefit – and provincial supplements that will vary in amount and design across the country. Some provinces, including British Columbia, Alberta, Saskatchewan, Quebec and New Brunswick, have already introduced or announced such supplements. The Canada Child Tax Benefit will provide a stronger platform for supplementary provincial benefits.

This approach should assist lower-income families with children by allowing each order of government to focus on what it can do best. The federal government is best positioned to run large-scale programs through the tax system. Provinces and territories are better placed to run programs that include regional variations and that respond quickly to changes in the needs and circumstances of individual families.

Action by the Government of Canada

Today, families with net income under \$25,921 receive a federal basic Child Tax Benefit of \$1,020 a year per child, an additional \$75 for the third and subsequent children in the family, and a further supplement of \$213 for each child under age seven when no child care expenses are claimed. Families with earned income can also receive a Working Income Supplement of up to \$500 per family.

In the 1996 budget, the federal government moved to help children by proposing a reform of Canada's child support system that included a change in the tax treatment of child support, the introduction of guidelines for child support award levels, new measures to improve the enforcement of support orders, and a two-step doubling to \$1,000 of the WIS under the Child Tax Benefit. The budget also made the child care expense deduction available to parents with children up to age 16 and to parents attending school full-time.

To complement the child support reform announced in the 1996 budget, this budget announces the intention of the government to support the provinces in establishing and expanding unified family courts, which play a key role in dealing effectively with family law disputes, including the issues of support, custody and access.

New Canada Child Tax Benefit

In this budget, the federal government is proposing to allocate \$850 million to increase the existing federal annual spending of over \$5.1 billion under the Child Tax Benefit. This includes \$600 million in new funds as of July 1998, in addition to the \$250 million increase in child benefits announced in the 1996 budget. This means that \$6 billion will be provided annually to Canadian families under the new Canada Child Tax Benefit.

Consistent with recent discussions, the federal government and the provinces are suggesting a restructuring of the Child Tax Benefit. Additional federal resources would be used to create an enriched and simplified child benefit for all low-income families to be complemented by supplementary provincial benefits to low-income working families. A possible design for the federal platform would be to replace the existing Child Tax Benefit and WIS by the new Canada Child Tax Benefit with a maximum of \$1,625 for the first child and \$1,425 for each additional child, with these maximums applying to all families with family net income up to \$20,921. (The supplement of \$213 per child for children under age seven in families not claiming child care expenses would be retained.)

Changes to federal-provincial child benefits should reduce current benefit disparities by increasing assistance to low-income working families while ensuring that total support for families on social assistance is not reduced. To accomplish this, an enriched federal benefit to all low-income families will require that most provinces adjust social assistance benefits and reallocate the savings

to assist children in low-income working families. Possible reallocations could include: the extension of in-kind benefits or services (e.g., pharmacare, dental care or child care) to low-income families not receiving social assistance, a child credit for low-income families (such as the British Columbia Family Bonus or the Quebec Integrated Child Allowance), or an earned income credit (such as the Alberta Family Employment Tax Credit).

The Minister of Human Resources Development will continue to work with the provinces and territories to define the design of complementary federal and provincial changes that serve to reduce child poverty and barriers to work. The federal government will work with First Nations, provinces and territories to ensure that First Nations' children, on reserve, benefit like other Canadian children from these initiatives.

The federal government is firmly committed to providing additional assistance to children in low-income families, and will put forward later this year a final proposal to enrich and simplify the Child Tax Benefit. The new Canada Child Tax Benefit is proposed to take effect by July 1, 1998, or earlier if that should prove possible.

Modified Working Income Supplement

As a first step to the creation of a National Child Benefit System, the federal government proposes to restructure the Working Income Supplement by moving it from a family basis to a per-child basis, and to further increase the assistance it provides. This will bring it closer into line with the structure of the basic Child Tax Benefit and child allowances under social assistance. Legislation will be introduced to implement the modified Working Income Supplement shortly, with a proposed effective date of July 1997. The change will enrich the WIS by about \$195 million, \$70 million more than the \$125 million increase proposed for July 1997 in the 1996 budget. This will result in higher costs of \$50 million in 1997-98 and \$20 million in 1998-99. For July 1997 to June 1998, the federal government proposes to pay a maximum Working Income Supplement of \$605 to one-child families and \$1,010 to two-children families. The maximum amount will be increased by \$330 for each additional child.

Helping Canadians with Disabilities

Canadians with disabilities face many barriers in everyday life. The federal government is committed to helping persons with disabilities participate as fully as possible in Canadian society. Measures have already been taken to assist persons with disabilities. The 1996 budget doubled the assistance provided through the tax credit for those who provide in-home care for family members with disabilities and promised a review of measures – including those in the tax system – for people with disabilities.

A federal task force, chaired by Andy Scott M.P., was appointed to consult with the disability community and has provided policy recommendations. As a result, the Vocational Rehabilitation of Disabled Persons Program – which improves the employment prospects of the disabled who want to join the workforce – has been extended for one year while a replacement program is developed in co-operation with the provinces. In addition, the Minister of Human Resources Development has announced that funding of voluntary and non-governmental groups helping persons with disabilities will be maintained at 1996-97 levels.

Additional tax assistance to people with disabilities

The task force emphasized the need to reduce the disability-related costs that currently stand in the way of full participation of Canadians with disabilities in Canadian society. The following tax measures are being proposed to this effect:

- The list of expenses eligible for the medical expense tax credit will be broadened to include: 50 per cent of the cost of an air conditioner necessary to help an individual in coping with a severe chronic ailment, disease or disorder to a maximum of \$1,000; 20 per cent of the cost of a van that is adapted or will be adapted within six months for the transportation of an individual using a wheelchair to a maximum of \$5,000; expenses incurred for moving to accessible housing; sign language interpreter fees; reasonable expenses relating to alterations of the driveway of the principal place of residence of an individual with severe and prolonged mobility impairment, to facilitate the individual's access to a bus; and an increase in the limit on part-time attendant care expenses from \$5,000 to \$10,000.

- The \$5,000 limit on the deduction for attendant care expenses that is currently available for disabled earners will be eliminated.
- Audiologists will be allowed to certify eligibility for the disability tax credit.
- The definition of a preferred beneficiary of a trust will be broadened to include adults who are dependent on others by reason of mental or physical infirmity.
- The *Customs Tariff* will be amended to provide duty-free entry for all goods designed for the use of persons with disabilities. This new provision was developed in the context of the tariff simplification review that was launched by the government in 1994.

Canadians with disabilities who enter the labour force often face additional costs and the potential loss of benefits provided by income security programs. In response to this, the budget proposes to introduce a refundable credit for low-income working Canadians with high medical expenses.

The refundable credit will supplement assistance provided through the existing medical expense tax credit. The maximum credit will be the lesser of \$500 and 25 per cent of eligible medical expenses. Individuals must have at least \$2,500 in earnings to qualify. To target assistance to those with low incomes, the basic benefit will be reduced by 5 per cent of family net income in excess of \$16,069.

These measures will increase tax assistance to Canadians facing significant medical costs by \$70 million annually.

Opportunities Fund for persons with disabilities

A significant number of Canadians with disabilities who are not in the labour force could work either part-time or full-time, if they were provided assistance to prepare for, find and keep jobs. Many who are currently relying on social assistance would rather work and be financially self-sufficient. Therefore, the government is introducing an Opportunities Fund of \$30 million a year over three years to promote the development of strategies to reduce barriers to participation. The Fund will assist these Canadians in integrating into the economic life of their communities and increasing their independence.

The Fund's primary objective will be to generate innovative projects that demonstrate best practices that can be shared across the country. The federal government will build on strong partnerships already in place with disability groups and the private sector to provide opportunities for persons with disabilities within a results-based accountability framework. These projects will be developed by the partners in conjunction with the provincial governments and the appropriate authorities in each province. What is learned from the projects supported by the Fund will assist all levels of government and the private sector to apply new knowledge in programming for persons with disabilities. During its third year, the activities of the Fund will be evaluated in order to determine future directions and federal involvement.

The federal government will continue to work with groups representing persons with disabilities to ensure the effectiveness of its assistance to disabled persons.

Support for Charitable Giving

Millions of Canadians participate in the improvement of their communities through volunteer work and charitable donations. In this regard, the government fully recognizes the increasingly important role the charitable sector is playing in meeting the needs of Canadians. It is thus important to ensure that charities are able to raise sufficient funds to finance their activities.

To support this, generous incentives are provided in the tax system. Corporate donors are allowed to deduct charitable gifts up to the applicable net income limit in calculating their taxable income, producing federal and provincial tax assistance of up to 43 per cent of the value of the donation.

For individual donors, a federal tax credit at the rate of 17 per cent is provided on the first \$200 of donations each year. A federal tax credit of 29 per cent is available for the portion of donations exceeding \$200 up to the applicable net income limit. The federal tax credit also reduces surtaxes and provincial taxes, which typically bring tax assistance to a maximum of 52 per cent of the value of the donation (as shown in Table 5.1). In other words, there is roughly a 50/50 partnership between the donor and governments.

Table 5.1*Maximum tax assistance for donations by individuals*

	Per cent
Federal charitable donations tax credit	29
Impact on federal surtaxes	2
Typical impact on provincial taxes and surtaxes	21
Total tax assistance	52

The government has taken steps in each of the last three budgets to make it easier for Canadians to contribute to charities. These measures have particularly helped charities attract donations from modest-income donors. For example, the threshold for the higher 29-per-cent credit was lowered from \$250 to \$200, and the amount of donations eligible for the credit was increased significantly.

The 1996 budget also indicated that more could be done. Following a thorough review of a number of proposals for improving tax assistance and consultations with the charitable sector, the government is proposing further enhancements to assist the charitable sector in raising funds.

Increased tax incentives for charitable giving

This budget proposes further measures to help all charities attract donations from modest-income Canadians. The government proposes to adopt a common limit of 75 per cent of net income for donations to all charities by individuals and corporations for the 1997 and subsequent taxation years – raising the limit for most charities from 50 per cent, and lowering the limit for donations to the Crown and Crown foundations from 100 per cent. With this proposal, all charities would be able to attract donations on a level playing field, as donors giving to different charities would receive equal tax assistance in almost all circumstances. For donations to charities other than the Crown, these proposals would result in the limit being raised from 20 per cent prior to the 1996 budget to 75 per cent.

Representations made by charitable groups, notably before the House of Commons Standing Committee on Finance, repeatedly stressed the need to facilitate large transfers of capital from individuals and corporations to charitable organizations. In this regard, many groups have noted that donations of appreciated capital property are not treated as generously as in the United States.

Tax assistance for charitable donations in Canada and the U.S.

Many have made comparisons between the donation patterns in the United States and Canada and the relationship this may have to the respective tax treatments of donations. Canada has a much more generous scheme for cash donations than the United States. In Canada, all taxpayers are able to benefit from charitable donations tax credits. In the United States, approximately 70 per cent of taxfilers elect to use a standard deduction, and therefore do not claim any deduction for charitable donations.

In Canada, for donations above \$200, donors receive combined federal and provincial tax relief up to 52 per cent of the value of the donation. In the United States, for the 30 per cent of taxpayers who do not claim the standard deduction, the maximum tax relief reaches 43 per cent of the donation, but only for very high income earners. At more modest-income levels, the gap in favour of greater generosity from the tax system in Canada is even more marked: tax assistance for a modest-income donor is only slightly lower, while it falls to only 32 per cent in the U.S.

Further, a number of initiatives in this and recent budgets encourage greater giving from Canadians with modest incomes: the increases in the net income limits for most donations from 20 to 75 per cent, as well as the reduction in the threshold for claiming the 29-per-cent credit from \$250 to \$200, will largely benefit donors of more modest incomes.

There is, however, a marked distinction in giving patterns between the two countries for larger donations of appreciated capital property. Donations of this type are much more important in the United States than in Canada. Many representations attribute this gap to the preferential treatment provided in the U.S. to donations of appreciated capital property through an exemption from capital gains tax.

The tax assistance accruing to donations of appreciated capital property depends on both the rates of tax credits or deductions, the rate at which any capital gains are included in income, and the length of time that the asset is held.

Experience in the U.S. indicates that the typical capital gain realized on the donation of appreciated capital property represents about 60 per cent of the value. For such a donation, the exemption from the 32-per-cent maximum tax on capital gains in a typical state thus produces tax assistance of 19 per cent in addition to the 43-per-cent tax assistance from the charitable donations deduction. This results in tax assistance on typical donations of property of up to 62 per cent in the U.S.

In addition to a further increase in the net income limit, this budget addresses the differential tax treatment of donations of capital between Canada and the United States. It is for this type of donation that the giving patterns are most different between the two countries, and where a change in Canada's tax system can have the largest impact on overall donations to charities.

This budget proposes to reduce the income inclusion rate on capital gains arising from certain donations to charities (other than private charitable foundations) by individuals and corporations from 75 to 37½ per cent. Donations that will be eligible will be those of securities – such as shares, bonds, bills, warrants and futures – that are listed on a prescribed stock exchange, where the donation is made between budget day and the end of the calendar year 2001. (Prescribed stock exchanges are listed in the *Income Tax Regulations*.) This substantial reduction in the income inclusion rate will facilitate the transfer of capital to charities. The restrictions of property to securities listed on prescribed stock exchanges will avoid potential problems associated with the valuation of properties. After five years, this provision will be terminated if it has not been effective in both increasing donations and distributing the additional donations fairly among charities.

This initiative will give Canadian charities access to the sort of large donations of securities that U.S. charities raise by providing a level of tax assistance for these donations that is comparable to that in the U.S. As Table 5.2 shows, for a donation of a security worth \$100, a full exemption from capital gains tax is not needed to achieve the same level of tax incentive as in the U.S.

Thus, with the reduction in the income inclusion rate, the Canadian system of tax incentives will be slightly more generous than the U.S. system for donations of publicly listed securities. Combined federal-provincial tax assistance on a typical donation of publicly listed securities in Canada will rise to as much as 64 per cent, compared to combined federal and state tax assistance of 62 per cent in a typical U.S. state. It is much more generous than the U.S. system for donations of cash. As a result, Canadian charities now have a powerful set of tools for raising the funds they need to meet the needs of Canadians.

Table 5.2
Comparison of treatment of donations of securities

	Canada	U.S.
Fair market value of donation	100	100
Top marginal tax rate for high-income earners ¹ (%)	52	43
Value of donations tax credit/deduction	52	43
Typical cost base of donation	40	40
Capital gains tax if not donated ²	24	19
Additional tax assistance for donations of securities ³	12	19
Total tax assistance	64	62

¹ Combined typical federal-provincial-state tax rates.

² In Canada, only 75 per cent of capital gains are included in income. In the U.S., the maximum federal-state tax rate on capital gains is about 32 per cent.

³ Total of donations tax credit/deduction, and reduction in capital gains tax (additional 37½-per-cent exclusion in Canada, full exemption in the U.S.).

Proposals to increase incentives for cash donations

The government received many representations to implement further incentives for cash donations, notably a “stretch” proposal that would provide a higher tax credit for donations by an individual that exceed his or her historical giving level. The principal reason that further incentives for cash donations are not proposed in this budget is that the Canadian tax system is already very generous for cash donations by donors at all income levels – far more generous than the U.S. system. There is already generally a 50/50 partnership between governments and the donor on donations over \$200. Also, these proposals would have increased complexity in the tax system, and resulted in revenue costs that could exceed the increase in donations.

A “stretch” incentive would notably create opportunities for taxpayers to maximize their credits by rearranging their donation patterns without actually giving more over time – e.g., by “bunching” donations in one year or by combining donations with a spouse. It would also create a significant increase in the complexity of the tax system for taxpayers to the point where the intended effect of the additional incentive could be largely lost as many taxpayers would not understand how the incentive works.

On balance, the government believes the goal of increasing overall donations to charities is best accomplished by directing the additional resources available for tax assistance at closing the gap with the U.S. with respect to large donations of securities.

Further changes are proposed to encourage donations of easements and covenants of ecologically sensitive land, and donations of depreciable capital property.

Increasing Canadians' confidence in the charitable sector

A number of changes are also proposed in this budget in order to ensure donors that they can continue to be confident that their donations are being put to good use. Notably, Revenue Canada will be given additional resources in order to improve its ability to ensure that charities comply with the provisions of the *Income Tax Act*. Revenue Canada will also provide information to charities on how to broaden the understanding of the tax assistance available for charitable donations, and will provide more information on charities to the public.

Strong incentives and a predictable framework

Together, these measures provide significant new resources worth \$95 million annually in additional federal tax assistance to encourage charitable donations. With this new assistance, the tax treatment of charitable donations becomes considerably more generous in Canada than in the United States, and provides charitable organizations a predictable framework under which to work over the coming years. This will benefit all parts of the charitable sector, including social service organizations, universities, hospitals, arts organizations and registered amateur athletic associations.

The measures proposed in this budget represent the government's response to a thorough and exhaustive review of the tax provisions relating to charities. The measures introduced in this and the past three budgets result in a comprehensive package of enhancements that make Canada's system of tax incentives for charitable donations very generous and provide additional resources to strengthen the integrity of the sector. With these measures, Canadians can be confident that, for the next five years, the charitable sector will have the tools to raise funds from modest donations and from larger donations of securities, both of which are essential to assist the charitable sector in meeting the needs of Canadians.

Ensuring a Sustainable Retirement Income System

Canada's balanced system of public and private pensions is widely seen as one of the best in the world. The government remains determined to put in place the changes that are needed to ensure that the public pension system can be sustained in the face of escalating costs as Canadians live longer, the population ages and the baby-boom generation retires. To this end, the government proposed in the 1996 budget a new Seniors Benefit, and has consulted provinces on changes to the Canada Pension Plan (CPP) to make it sustainable, affordable and fair across generations of Canadians.

A new Seniors Benefit

The Seniors Benefit, which will begin in 2001, will help to make the public pension system more financially sustainable and thereby preserve benefits for future generations. By creating a fairer and more targeted system of assistance for seniors, the Seniors Benefit will slow the growth in costs of public pensions.

The legislation to be put before Parliament will implement the proposals outlined in the 1996 budget:

- The new benefit will be implemented in a manner that meets the government's commitment to today's seniors that their old age security and guaranteed income supplement (GIS) payments will not be reduced and broadens this commitment to apply to everyone age 60 and over as of December 31, 1995.
- Under the Seniors Benefit, the vast majority of seniors – those with incomes up to about \$40,000 – will be as well or better off; 75 per cent of single seniors and senior couples will receive the same or higher benefits. Nine out of 10 single senior women will be better off.
- Those most in need will be protected. Indeed, GIS recipients will receive an additional \$120 a year.
- The benefit levels and threshold will be fully indexed to inflation. This is an improvement over the current system where the thresholds are not fully indexed.
- For couples, the amount of the payment will be determined on the basis of the combined income of spouses, as is the case now with the GIS.

- The new Benefit will be completely tax free and will incorporate the existing age and pension income tax credits.
- The benefits will be delivered in a single monthly payment which, for couples, will be made in separate and equal cheques to each spouse.
- The Spouse's Allowance Program will remain in place and payments will be increased by \$120 per year.

The legislation to implement the Seniors Benefit will also include three small changes to the GIS to improve the operation of the program until the Seniors Benefit is introduced in 2001. These changes are expected to take effect in 1998. The main proposed change is a shift in the annual renewal date for GIS from April to July. Providing more time for the processing of renewal applications and allowing benefits to be calculated from the income tax return will ensure that payments to seniors will not be interrupted by processing delays. The other changes will adapt the GIS formula to modern computerized calculations and harmonize income definitions more closely with income tax provisions.

Securing the future of the Canada Pension Plan

The federal government and the provinces are joint stewards of the Canada Pension Plan. Any changes to it require the agreement of the federal government and two-thirds of the provinces with two-thirds of Canada's population.

The federal government has been working with provinces and territories over the past year to find ways of ensuring that the CPP is sustainable for future generations. Based on a joint paper, public consultations were held last spring in every province and territory and a report was released summarizing what Canadians told their governments about how to fix the CPP.

The report indicated that Canadians value the CPP and want it preserved and protected as a key pillar of the retirement income system. They urged governments to move quickly to put the CPP on a sound financial footing and to ensure that it will be there for them when they need it.

All governments have endorsed principles to guide changes to the CPP. The principles are:

- The CPP is a key pillar of Canada's retirement income system that is worth saving.

- The CPP is an earnings-related program. Its fundamental role is to help replace earnings upon retirement or disability, or the death of a spouse – not to redistribute income. The income redistribution role is the responsibility of the income tax system – the Old Age Security/Guaranteed Income Supplement/Seniors Benefit, and other income-tested programs paid from general tax revenues.
- The solutions to the CPP's problems must be fair across generations and between men and women.
- The CPP must be affordable and sustainable for future generations. This requires fuller funding and a contribution rate no higher than the already legislated future rate of 10.1 per cent. In deciding how quickly to move to this rate, governments must take economic and fiscal impacts into account.
- Governments must tighten administration as the first step towards controlling costs.
- Disability and survivor benefits are important features of the CPP. However, they must be designed and administered in a way that does not jeopardize the security of retirement pensions.
- Any future benefit improvements must be fully funded.
- CPP funds must be invested in the best interests of plan members, and maintain a proper balance between returns and investment risk. Governance structures must be created to ensure sound fund management.
- Governments must monitor changing economic, demographic and other circumstances which can affect the CPP, and act to respond to these changing conditions. Annually, ministers of finance should provide Canadians with the appropriate information so they can judge for themselves that the integrity and security of the CPP is being protected.

Pension adjustment reversal

Individuals who leave pension plans before retirement often receive termination benefits that are low in relation to the benefits promised under the plan. The result is a loss of savings that makes it more difficult for such individuals to accumulate adequate levels of retirement income. This is a particular problem for individuals who might have several employers over their career and women leaving the workforce on a temporary basis to raise children.

The budget proposes to restore savings opportunities for such individuals by introducing a pension adjustment reversal (PAR). The PAR will restore lost registered retirement savings plan (RRSP) room when an individual receives a termination benefit from a pension plan that is low relative to the RRSP room given up while a plan member. The PAR will make the retirement savings system fairer and more effective in helping Canadians build adequate retirement incomes.

Table 5.3
Investing in a stronger society

	1997-98	1998-99	1999-2000
(millions of dollars)			
Sustaining and improving Canada's health care system			
Health Transition Fund/Canada Health Information System	50	75	75
Community Action Program for Children and Canada Prenatal Nutrition Program	33	33	33
Subtotal	83	108	108
Toward a National Child Benefit System			
Canada Child Tax Benefit	50 ¹	470 ¹	600
Helping Canadians with disabilities			
Broadening the medical expense tax credit/removing limit on attendant care deduction	5	30	30
Refundable medical expense supplement for earners	5	30	40
Opportunities Fund	30	30	30
Subtotal	40	90	100
Support for charitable giving			
Reduced inclusion rate on capital gains	20	90	90
Net income limit/CCA recapture changes	5	5	5
Increased resources for Revenue Canada	5	5	5
Subtotal	30	100	100
Total	203	768	908

¹ Assumes a July 1, 1998 start-up. If implemented earlier, total would be larger by up to \$150 million.

Annex 1

The Budgetary Deficit, Financial Requirements, and the National Accounts Deficit

There are three basic measures of the federal government's fiscal position in Canada – two measures based on the public accounts (the budgetary deficit or surplus and financial requirements or sources) and one based on the System of National Accounts, as prepared by Statistics Canada. Corresponding to each measure are indicators of the net debt position of the federal government.

Differences in the measures arise because the accounting frameworks are designed for different purposes.

The fundamental purpose of the first two measures (budgetary deficits or surpluses and financial requirements or sources – public accounts measures) is to provide information to Parliament on the government's financial activities as required under the *Financial Administration Act*. The purpose of the public accounts is to permit parliamentary control of public funds into and out of the Consolidated Revenue Fund. It measures the difference between cash revenues in a year and obligations incurred by the Government of Canada in that year, excluding those in respect of the Canada Pension Plan (CPP). The results are based on generally accepted accounting principles for the public sector and are audited by the Auditor General of Canada.

Financial requirements measure the amount by which cash going out from the government exceeds cash coming in. It is equal to the amount of money that the government has to borrow in credit markets. The budgetary deficit or surplus includes all transactions

with outside parties that enter into the calculation of the deficit or surplus of the government. The budgetary deficit or surplus is a more comprehensive measure as it includes liabilities incurred during the year for which no cash payment has been made and only those revenues and program spending over which Parliament has given it control.

- The main difference between the budgetary deficit and financial requirements relates to the treatment of federal government employees' pension accounts. The budgetary deficit includes the total annual pension-related obligations (the government's contribution as an employer for current service costs plus interest on its borrowings from the pension accounts) while financial requirements include only the benefits paid out in that year less employee premiums paid.
- In addition, the budgetary deficit or surplus includes all the federal government's obligations incurred during the course of the year while financial requirements only include the actual cash outlay related to these obligations.

Most industrialized countries present their budgets on a basis that is more comparable to the financial requirements approach than to the public accounts measure of the budgetary deficit.

Financial requirements correspond closely to the Unified Budget Balance in the United States.

The primary objective of the national accounts is to measure economic production and income. Thus, the government sector is treated on the same basis as other sectors of the economy. The primary objective of measuring economic activity means that certain transactions are recorded on an accrual basis in order to measure when revenues and expenditures are incurred. In addition, the current national accounts treatment of the transactions of federal government employees' pension accounts is similar to that in the public accounts measure of financial requirements.

- The national accounts deficits or surpluses are largely used for international fiscal comparisons by the Organization for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF).
- The national accounts also provide a consistent framework for aggregation and comparison of the fiscal positions of the various levels of government in Canada.

Each measure provides important complementary perspectives on the government's fiscal position.

- Although the levels are different, the trends are broadly similar (Table A1.1).
- Financial requirements and the national accounts deficit are currently broadly similar in level and both are considerably lower than the public accounts deficit, reflecting the inclusion of the net amount of federal government employees' pension funds.

As the deficits or surpluses derived from these three measures are different, so are the measures of debt (Table A1.2). The accumulation of annual budgetary deficits and surpluses since Confederation is the net public debt. For financial requirements, the relevant measure is unmatured debt – the stock of market debt that the government has outstanding. The national accounts debt represents the government's total liabilities minus its financial assets.

Table A1.1

*Alternative measures of the federal budget balance
1980-81 to 1995-96 (fiscal years)*

Year	Budgetary surplus or deficit (-)		Financial requirements (excluding foreign exchange transactions)		National accounts surplus or deficit (-)	
	Millions of dollars	Per cent of GDP	Millions of dollars	Per cent of GDP	Millions of dollars	Per cent of GDP
1980-81	-14,556	-4.7	-9,917	-3.2	-9,604	-3.1
1981-82	-15,674	-4.4	-9,264	-2.6	-9,062	-2.5
1982-83	-29,049	-7.8	-23,819	-6.4	-23,486	-6.3
1983-84	-32,877	-8.1	-25,219	-6.2	-25,957	-6.4
1984-85	-38,437	-8.6	-29,824	-6.7	-32,584	-7.3
1985-86	-34,595	-7.2	-30,510	-6.4	-27,872	-5.8
1986-87	-30,742	-6.1	-22,918	-4.5	-24,089	-4.8
1987-88	-27,794	-5.0	-18,849	-3.4	-19,510	-3.5
1988-89	-28,773	-4.7	-22,424	-3.7	-20,592	-3.4
1989-90	-28,930	-4.4	-20,530	-3.2	-22,253	-3.4
1990-91	-32,000	-4.8	-24,538	-3.7	-27,416	-4.1
1991-92	-34,357	-5.1	-31,800	-4.7	-28,702	-4.2
1992-93	-41,021	-5.9	-34,497	-5.0	-31,060	-4.5
1993-94	-42,012	-5.9	-29,850	-4.2	-35,077	-4.9
1994-95	-37,462	-5.0	-25,842	-3.5	-28,561	-3.8
1995-96	-28,617	-3.7	-17,183	-2.2	-25,437	-3.3

Table A1.2
*Alternative measures of the federal debt
 1980-81 to 1995-96 (fiscal years)*

Year	Net debt		Unmatured debt		National accounts debt ¹	
	Millions of dollars	Per cent of GDP	Millions of dollars	Per cent of GDP	Millions of dollars	Per cent of GDP
1980-81	91,948	29.7	83,138	26.8	49,609	16.0
1981-82	107,622	30.2	93,167	26.2	57,817	16.2
1982-83	136,671	36.5	116,562	31.1	79,547	21.2
1983-84	169,549	41.8	142,901	35.2	105,765	26.1
1984-85	207,986	46.8	172,719	38.8	136,620	30.7
1985-86	242,581	50.8	201,229	42.1	169,619	35.5
1986-87	273,323	54.1	228,611	45.2	195,919	38.7
1987-88	301,117	54.6	250,809	45.5	215,613	39.1
1988-89	329,890	54.4	276,301	45.6	236,708	39.1
1989-90	358,820	55.1	294,562	45.3	262,021	40.3
1990-91	390,820	58.4	323,903	48.4	287,618	43.0
1991-92	425,177	62.9	351,885	52.0	309,189	45.7
1992-93	466,198	67.6	382,741	55.5	340,699	49.4
1993-94	508,210	71.3	413,975	58.1	366,494	51.4
1994-95	545,672	73.0	440,998	59.0	401,815	53.8
1995-96	574,289	74.0	469,547	60.5	428,976	55.3

¹ National accounts debt figures represent net financial assets on a calendar year basis.

Source: Statistics Canada, National Balance Sheet Accounts (Cat. 13-214, category 2000).

Annex 2

Improved Fiscal Outlook for the Total Government Sector

Introduction and Overview

This annex first provides an assessment of the government financial situation at both the federal and provincial-territorial levels. The total government fiscal situation in Canada is then contrasted with that of the other Group of Seven (G-7) countries.

The fiscal situation of the federal-provincial-territorial sector (defined as the total government sector on a public accounts basis) in Canada in terms of the deficit, program spending, operating balance and debt servicing costs has improved significantly. Further progress is anticipated over the next two years.

The extent of fiscal progress in Canada becomes even stronger when put in an international context. In 1997, Canada's total government position will be very favourable in relation to the G-7 nations – a considerable feat, given the situation at the beginning of the decade.

Federal-Provincial-Territorial Fiscal Situation

Joint efforts towards lower deficits

Both the federal and the provincial-territorial governments have made significant progress in reducing their budgetary imbalances.

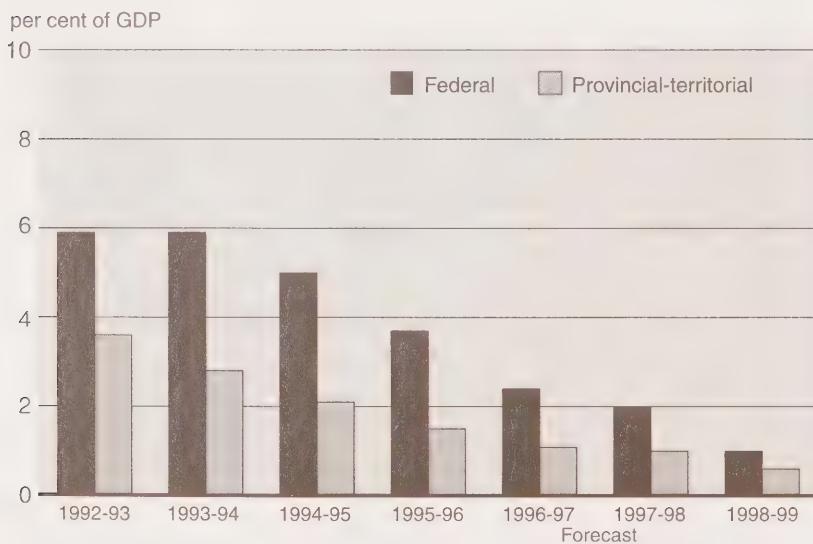
On a public accounts basis, it is projected that the total government deficit will have been reduced by 58 per cent from 1992-93 to 1996-97. As a proportion of gross domestic product (GDP), the federal deficit will be reduced from 5.9 to 2.4 per cent of GDP, and the provincial-territorial deficit from 3.6 to 1.1 per cent (Chart A2.1).

A majority of provinces are expected to report a balanced budget or even a budgetary surplus in 1996-97. In the latter cases, the allocation of budgetary surpluses is gradually becoming a topic of public policy debate. Several jurisdictions have already implemented balanced budget legislation and/or announced schedules for the repayment of the public debt.

From a target of 2 per cent of GDP in 1997-98, the federal deficit is projected to decline further to a target of 1 per cent in 1998-99, resulting in the elimination of the requirement for new borrowing.

Chart A2.1

*Federal and provincial-territorial budgetary deficits
(public accounts basis)*



Source: Department of Finance, Canada.

This performance, combined with the steady decline in the provincial-territorial deficit, will result in a total federal-provincial-territorial deficit of some 1.5 per cent of GDP by 1998-99, compared with 9.6 per cent in 1992-93.

Lower program spending remains the cornerstone of deficit reduction success

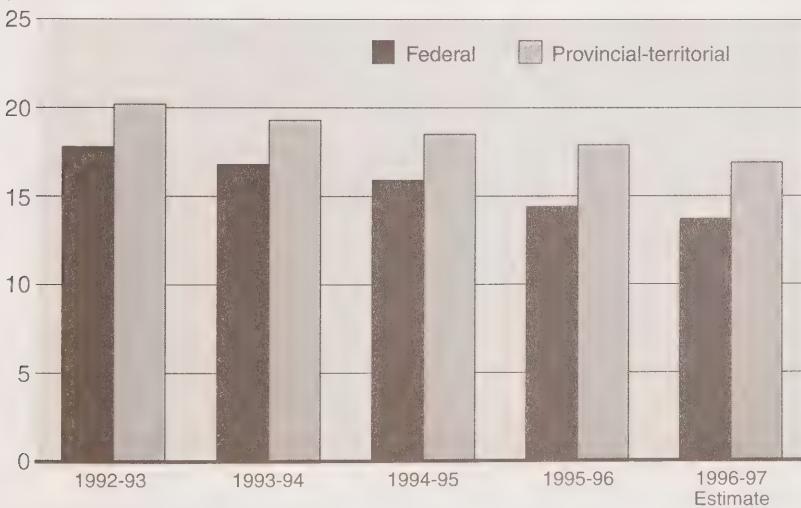
The strategy at both levels of government has largely focused on reducing program spending relative to the size of the economy (Chart A2.2). Federal program spending has declined dramatically over the past few years, falling from 17.8 per cent of GDP in 1992-93 to 13.7 per cent in 1996-97. Federal revenues have remained relatively constant as a share of GDP over this period.

At the provincial-territorial level, the ratio of program spending to GDP declined by 3.3 percentage points between 1992-93 and 1996-97 reaching 16.9 per cent. Provincial revenues have fallen slightly over this period as a share of GDP.

Chart A2.2

*Federal and provincial-territorial program spending
(public accounts basis)*

per cent of GDP



Source: Department of Finance, Canada.

Over the next two years, program spending is expected to continue its decline in nominal terms at both levels of government. Consequently, the expected ratios of program spending to GDP will follow a steady downward path, further contributing to balancing the books.

Operating balances move into surplus positions

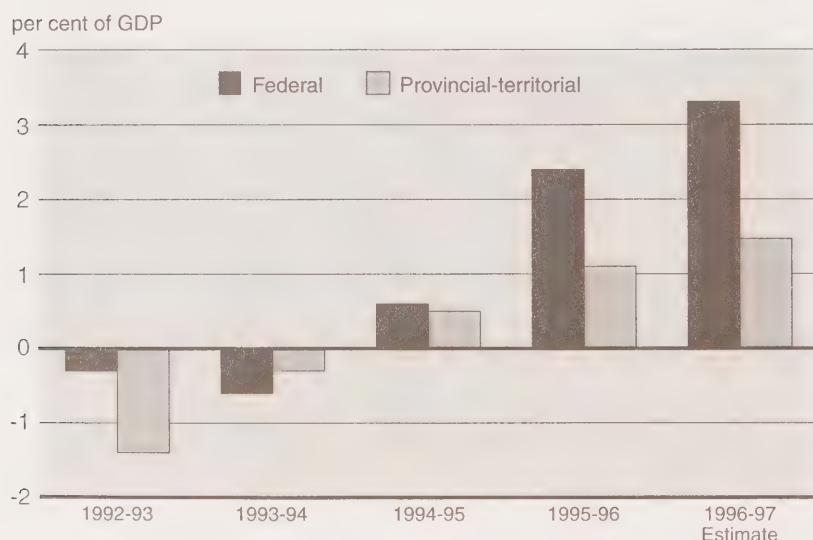
The fiscal policy course on which the federal and provincial-territorial governments are embarked has resulted in significantly improved operating budget surpluses, defined as the difference between total budgetary revenues and program spending. An operating surplus is an important indicator of fiscal policy sustainability, particularly with respect to the level of public debt. Sufficiently large operating surpluses contribute to the stabilization and then to the reduction of the debt-to-GDP ratio.

At both levels of government, the operating budget surplus has been increasing rapidly since moving from a deficit to a surplus position in 1994-95.

The federal and provincial-territorial operating surpluses are expected to reach 3.3 and 1.5 per cent of GDP, respectively, in 1996-97 (Chart A2.3).

Chart A2.3

*Federal and provincial-territorial operating balances
(public accounts basis)*



Source: Department of Finance, Canada.

Over the next two years, the federal operating surplus is projected to increase further to reach 4.7 per cent of GDP in 1998-99.

Lower interest rates are beneficial

Canada's excellent inflation performance and the sharp improvement in the federal and provincial-territorial fiscal situation have led to increased confidence in financial markets and much lower interest rates.

Short-term interest rates have declined by more than 500 basis points since January 1995, while 10-year bond rates are some 300 basis points lower. The implied reduction in debt servicing costs has also contributed significantly to the gradual elimination of deficits or, in some cases, the accumulation of surpluses.

Consequently, despite the increase in the debt level of the total government sector in 1996-97, total debt charges are estimated to have declined. As a proportion of GDP, they are forecast to decline at both the federal and provincial-territorial levels this year and next.

Debt burdens are declining

With program spending declining rapidly as a proportion of GDP and debt servicing costs to a lesser extent, the net debt-to-GDP ratio will decline significantly in 1997-98 for the first time since the early 1980s.

Led by the federal government, the total government debt-to-GDP ratio is expected to decline by some 4 percentage points by 1998-99, as compared to its peak level in 1996-97.

Canada's Fiscal Gains in an International Context

International fiscal comparisons can sometimes be difficult for two reasons. First, differences in accounting practices across countries hamper comparability of fiscal data. Second, fiscal responsibilities of each country are shared differently among its levels of government. It is for these reasons that national accounts data for the total government sector are used for the following G-7 comparisons,

as these data are more consistent across countries. Canada and the Organization for Economic Co-operation and Development present a comprehensive set of estimates on a national accounts basis.

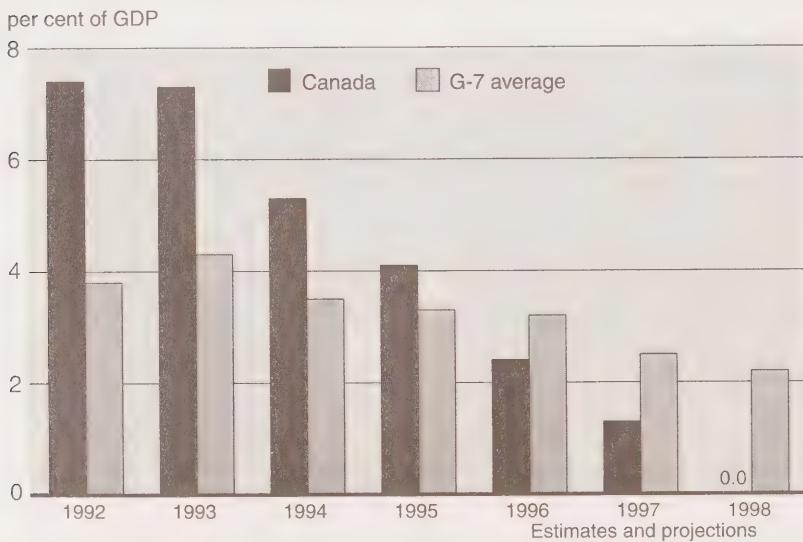
On the basis of these data, the following charts illustrate that Canada has made significant fiscal progress relative to the other G-7 countries.

Canada's deficit in terms of GDP lowest of the G-7

In 1992, the Canadian total government deficit (national accounts basis) stood at 7.4 per cent of GDP, nearly double the G-7 average of 3.8 per cent.

By 1997, the situation will have been completely reversed. The Canadian total government deficit will be nearly half the G-7 average of 2.5 per cent, at 1.3 per cent of GDP (Chart A2.4). In fact, the 1997 Canadian total government deficit will be the lowest of the G-7 countries (Chart A2.5). By 1998, the Canadian total government deficit-to-GDP ratio is expected to be roughly in balance, and remain the lowest of the G-7 countries. This is in stark contrast to the situation only five years ago.

Chart A2.4
*Total government deficit
 (national accounts basis)*

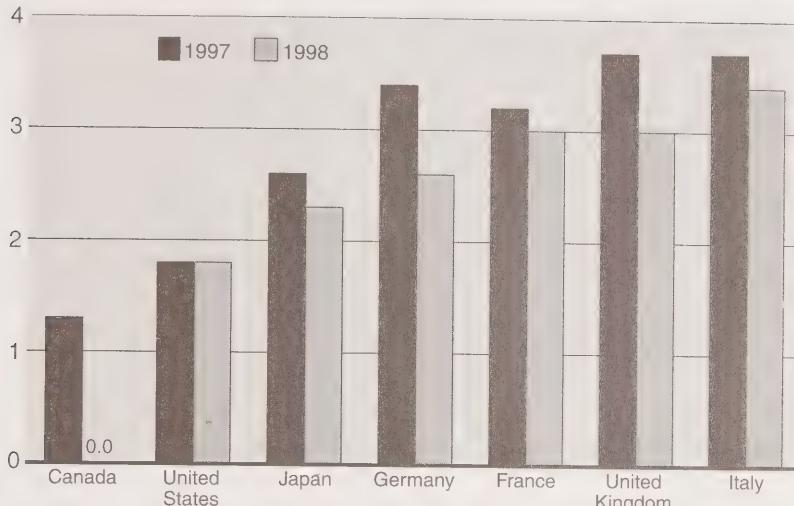


Sources: Canada, Department of Finance; G-7 average, OECD Economic Outlook Data, December 1996.

Chart A2.5

*Total government deficit in G-7 countries
(national accounts basis)*

per cent of GDP



Sources: Canada, Department of Finance; other G-7 countries, OECD Economic Outlook Data, December 1996.

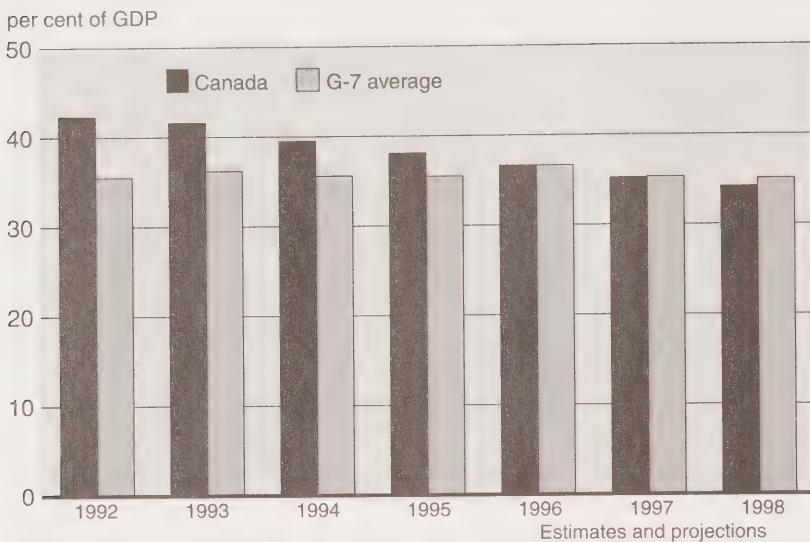
Program spending is the key factor in fiscal consolidation

The gap in program spending as a proportion of GDP between Canada and the G-7 average is also narrowing and will be eliminated in 1997 (Chart A2.6).

In 1997, the ratio of program spending to GDP in Canada will be the third lowest behind the United States and Japan (Chart A2.7). This is expected also to be the case in 1998.

Chart A2.6

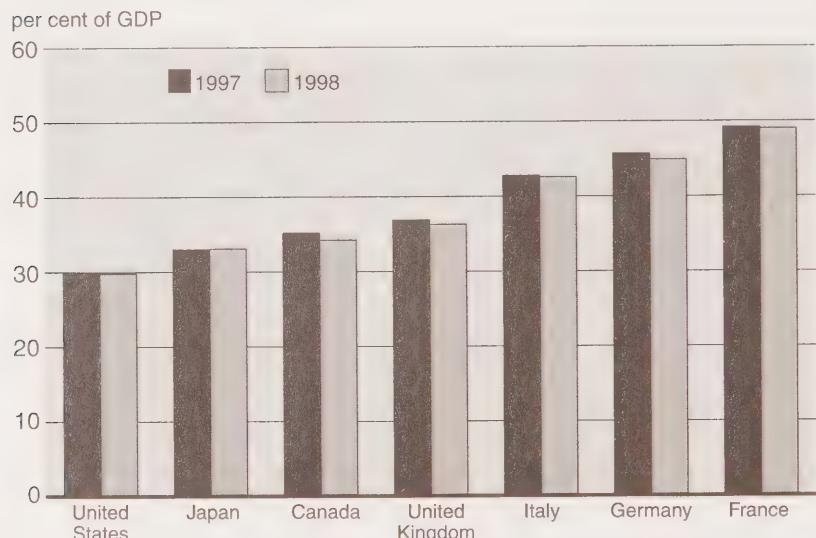
*Total government program spending
(national accounts basis)*



Sources: Canada, Department of Finance; G-7 average, OECD Economic Outlook Data, December 1996.

Chart A2.7

*Total government program spending in G-7 countries
(national accounts basis)*



Sources: Canada, Department of Finance; other G-7 countries, OECD Economic Outlook Data, December 1996.

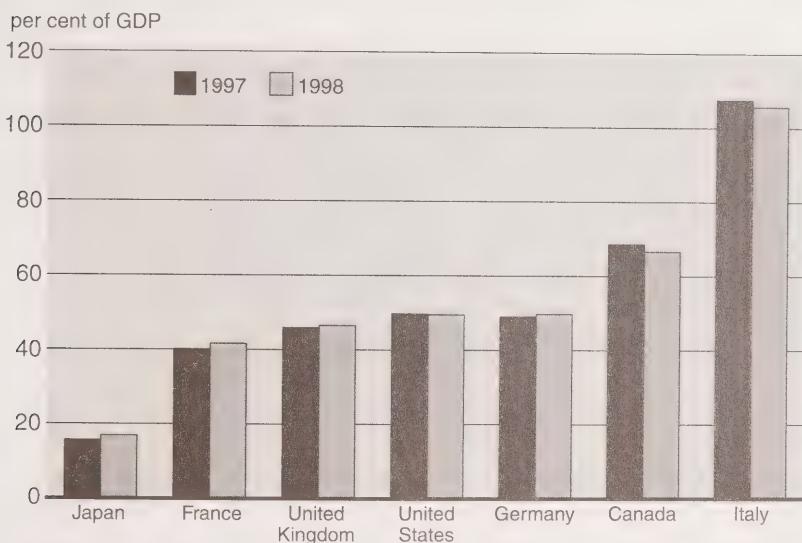
The Canadian net debt-to-GDP ratio declines more rapidly

Although the Canadian net debt-to-GDP ratio is higher than the G-7 average, it is projected to start declining at a more rapid rate than the average in line with the gains made in deficit reduction.

Between 1997 and 1998, the Canadian net debt ratio will decline by 2 percentage points, the largest decline among the G-7 countries (Chart A2.8).

Chart A2.8

*Total government net debt in G-7 countries
(national accounts basis)*



Sources: Canada, Department of Finance; other G-7 countries, OECD Economic Outlook Data, December 1996.

Annex 3

Fiscal Outlook: Sensitivity to Economic Assumptions

Sensitivity to Changes in Economic Assumptions

Estimates of the main fiscal aggregates are sensitive to changes in economic assumptions – particularly to the level of nominal gross domestic product (GDP) and interest rates. The following sensitivity estimates capture the direct fiscal impacts of changes, one economic variable at a time. These are partial calculations. For example, in the nominal income sensitivity estimate, there is no feed-through of the change in nominal income to other variables, such as interest rates and unemployment.

Sensitivity to changes in nominal income

A 1-per-cent increase in the level of nominal GDP leads to higher tax bases and thus higher revenues. The ultimate deficit impact would depend on the source of the increase in nominal incomes. The most favourable impact on the fiscal situation would occur if all the increase in nominal GDP resulted from increased real output. Revenues would be higher and borrowing costs lower. Interest rates would be relatively stable.

If, however, the improvement in nominal GDP was solely due to inflation, then some of the positive impact of government revenues would be offset by higher spending on those programs indexed to inflation. Higher inflation would also likely raise interest rates.

Assuming the increase in nominal incomes comes solely from an increase in output with no impact on interest rates, the deficit would be lowered by \$1.3 billion in the first year, rising to \$1.7 billion after four years (Table A3.1).

Table A3.1*Fiscal sensitivity analysis: 1-per-cent increase in nominal income*

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue increases	1.2	1.3	1.4	1.6
Expenditure reductions	0.1	0.2	0.1	0.1
Deficit reduction	1.3	1.5	1.5	1.7

Sensitivity to changes in interest rates

In contrast to the uncertainties of the sensitivity of the deficit to changes in nominal GDP, the direct impact of interest rate changes on public debt charges can be calculated with considerable precision.

A sustained 100-basis-point increase in all interest rates would cause the deficit to increase by \$1.0 billion in the first year (Table A3.2). As longer-term debt matures and is refinanced at the higher interest rates, the negative impact on the deficit increases, such that by year four, the deficit is about \$2.6 billion higher.

Table A3.2*Fiscal sensitivity analysis: 100-basis-point increase in all interest rates*

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue increases	0.5	0.5	0.5	0.5
Expenditure increases	1.5	2.4	2.8	3.1
Deficit increase	1.0	1.9	2.3	2.6

These estimates are somewhat lower than estimates contained in previous budgets because the government is increasing the fixed-rate portion of the debt (the percentage of the gross debt issued as longer-term fixed-rate instruments) towards a target of 65 per cent in order to bring more stability to debt charges.

The establishment of a prudent debt structure that has more stable long-term financing is one of the key steps to putting Canada's financial house in order, and is essential to maintaining investor and credit rating agency confidence. Canada's past reliance on short-term debt was noted by market participants and credit rating agencies – a concern which, if unaddressed, could have raised Canada's overall cost of debt. Over the last four years, the government has significantly reduced its exposure to unexpected changes in interest rates. The fixed element of the debt stock has been increased from 52 to 62 per cent, with the target of 65 per cent expected to be reached in the near future. By ensuring the government meets its objective of raising stable, low-cost funding, a prudently structured debt stock benefits all taxpayers and brings Canada into line with international standards. For further information, refer to the *Debt Operations Report*, Department of Finance, November 1996.

Annex 4

The Government's Response to the Auditor General's 1996 Reports and Observations on the Financial Statements

For the fifth consecutive year, the Auditor General has expressed a clean opinion on the government's financial statements. In the opinion of the Auditor General, the deficit outcome of \$28.6 billion for 1995-96 represents "fairly, in all material respects, the financial deficit of the Government of Canada for the year ended March 31, 1996 ... in accordance with the stated accounting policies of the Government of Canada".¹

However, as in previous years, the Auditor General has raised a number of accounting issues in his "Observations" on the 1996 financial statements of the Government of Canada. These are:

- recording of the transitional assistance for harmonizing the federal and provincial sales taxes;
- accounting for employee pensions;
- full accrual accounting for capital assets;
- accrual accounting for tax revenue;
- accounting for environmental liabilities and contingencies; and
- accounting for Enterprise Crown corporations.

The government's responses to these issues are discussed in this annex.

¹ *Public Accounts of Canada, 1995-96 Volume 1.5.*

Recording of Transitional Assistance for Harmonizing Federal and Provincial Sales Taxes

During the course of 1995-96, the government undertook detailed negotiations with a number of provinces to harmonize the federal goods and services tax (GST) with the provincial sales taxes (PSTs). As a result of these negotiations, agreements were reached with the provinces of New Brunswick, Nova Scotia, and Newfoundland and Labrador. As part of these agreements, the federal government provided transitional assistance totalling \$961 million for part of the revenue shortfalls that these provinces would experience in the first three years under the harmonized system. The government recorded this liability of \$961 million in 1995-96.

In his observations to the 1996 financial statements, the Auditor General stated that the transitional assistance of \$961 million should be included in the deficit subsequent to 1995-96. According to the Auditor General, not all the eligibility criteria to book the transitional assistance were met in 1995-96.

Under accounting policies recommended by the Canadian Institute of Chartered Accountants' Public Sector Accounting and Auditing Board (PSAAB), and endorsed by the government, government transfers should be recognized in a government's financial statements as expenditures in the period that the events giving rise to the transfer occurred, as long as:

- the transfer is authorized;
- eligibility criteria, if any, have been met by the recipient; and
- a reasonable estimate of the amount can be made.

In the view of the Auditor General, the second criterion had not been met by the three provinces by March 31, 1996, as the detailed agreements with the three provinces and the federal government were not in place by March 31, 1996.

The federal government disagrees with this view. Although the *final* agreements were not signed until the fall of 1996, the federal government made an *irrevocable* offer to those provinces, and only to those provinces that had indicated in a written memorandum of understanding to the federal government before March 31, 1996 that they would harmonize their provincial sales tax with the federal tax. Authorization to make these payments was included as part of

the 1996 budget legislation which received Royal Assent prior to the closing of the financial statements for 1995-96. In addition, the federal government is of the view that it must be held accountable to Parliament and the Canadian public for the liabilities that it incurs – in the year those liabilities are incurred even if the applicable legislation is not passed and/or final agreements completed before the end of the fiscal year. The offer made to the three provinces in 1995-96 represented such a liability and thus was appropriately recorded in the year that it was incurred.

However, as the Auditor General noted in his observations, the booking of this liability did not materially affect the reported deficit outcome of \$28.6 billion for 1995-96.

Accounting for Employees' Pensions

The government is responsible for the defined benefit plans, covering substantially all its full-time employees (including the Public Service, Canadian Forces, Royal Canadian Mounted Police and certain Crown corporations), as well as federally appointed judges and Members of Parliament.

Annually, the actuarial pension obligations to these plans are estimated by projecting benefits expected to be paid in the future and calculating their present value. Many assumptions are required for this process, including estimates of future inflation, interest rates, general wage increases, workforce composition, retirement rates and mortality rates.

The actuarial obligation was estimated at \$87 billion at March 31, 1996. This compares to the pension account liability of \$110 billion as determined by legislation. This liability is comprised of the accrued benefit obligation of \$87 billion, plus unamortized pension adjustments of \$23 billion. This liability is based on the contributions into the plans (both employee and employer), less benefits paid, plus the interest credited on plan balances. There are a number of reasons for this difference, primarily relating to the assumptions used in calculating the actuarial pension obligations. And, as noted by the Auditor General, this difference is expected to grow over time.

The Auditor General notes that this difference could likely be reduced if the government changed the manner in which pension interest is calculated. Presently, the government credits the interest

on the basis of total pension account liability, as required by legislation. The PSAAB, however, recommends that pension interest be calculated on the basis of the actuarial obligation for accounting purposes. The Auditor General notes that if the interest was credited on the actuarial obligation only (i.e. on the \$87 billion rather than the \$110 billion), then the difference between the actuarial obligation and the liability reported on the Statement of Assets and Liabilities would be reduced over time.

The government is concerned about this growing difference and is amortizing it over periods ranging from 7 to 14 years, as required by generally accepted accounting practices set out by the PSAAB. However, the government is willing to explore measures with the Auditor General to address this issue.

Capitalization of Physical Assets

As announced in the 1995 budget, the government intends to move to full accrual accounting for budgeting and accounting purposes. The accrual basis, which is widely used in the private sector in Canada, will allow the government to report more accurately the cost of its activities on an annual basis and thereby ensure that it is more accountable to Parliament and the public.

The Auditor General supports this move to a better accounting for capital assets, but recommends that it be done at the program level and in compliance with generally accepted accounting principles when reporting them at a summary level.

During the course of 1996, the Treasury Board Secretariat issued a proposed policy on accounting for capital assets. The PSAAB approved, for public comment, guidelines on how federal and provincial governments should account for and report tangible capital assets. In his observations to the 1996 financial statements, the Auditor General notes that he is encouraged by the government's efforts in this area and encourages the government to follow the PSAAB's recommendations as they evolve.

The government will continue to work with the Auditor General to implement accrual accounting for capital assets in a responsible way.

Accrual Accounting for Tax Revenue

In the 1996 budget, the government announced its intention to report tax revenues on an accrual basis of accounting. In his observations, the Auditor General applauds this move but cautions that full accrual of tax revenues represents a significant challenge as most systems at Revenue Canada will need to be modified. He encourages the government to take the time necessary to ensure the integrity and auditability of that information.

The government is well aware of the challenges that accrual accounting of tax revenues present. Revenue Canada and the Treasury Board Secretariat are working closely with the Office of the Auditor General to ensure that his concerns are being addressed.

Accounting for Environmental Liabilities and Contingencies

This observation has been raised by the Auditor General in previous years. The environmental liabilities of the government are likely significant. The government has not yet recognized these liabilities in its financial statements because of uncertainties in defining and estimating them. The Auditor General is of the view that steps can and should be taken now to provide a more complete picture of environmental liabilities and costs in the financial statements.

The Auditor General recommends that high priority be given to quantifying the government's potential environmental liabilities, and to determining when these potential liabilities become actual liabilities. As well, the Auditor General recommends that additional steps should be taken to improve disclosure in this area. He is particularly concerned that the government provide a general understanding of the uncertainties inherent in the process of measuring environmental liabilities – including a discussion of the assumptions used to calculate the liabilities and the range of sensitivities to changes in the assumptions.

This is a very complex area. The government is in the process of developing policies with regard to accounting for environmental liabilities.

Investments in Crown Corporations

In the 1996 budget, the government announced its intention to adopt the PSAAB's recommendations that profits and losses reported by Enterprise Crown corporations be included in the government's deficit or surplus for that year. This is in contrast with the current practice of recording such investments at cost and making appropriate adjustments through allowances. The Auditor General notes his support for this change. The government will introduce this change with the move to accrual accounting.

Annex 5

Tax Fairness

Introduction

Canadian governments provide a variety of services to citizens and the principal source of revenue to finance them is taxes. In raising revenue, it is essential for governments to use a tax system that is fair which means applying the following key principles:

- **taxes must reflect the ability to pay** – those with similar incomes and in similar circumstances should pay similar taxes, but those with higher incomes must pay more. When feasible, those with higher incomes should pay progressively more taxes. Corporations must also pay taxes in Canada on their profits prior to their distribution to either domestic or foreign shareholders;
- **those who need help get it** – the tax system must recognize special circumstances that affect the ability to pay tax and should indeed be capable of actually providing assistance to, rather than levying taxes on, those in greatest need; and
- **taxes that are owed are indeed paid** – this involves compliance with the tax system. The government must ensure that Canadians clearly understand their legal obligations and that Revenue Canada collects taxes that are owed in a fair and efficient manner both for the government and taxpayers.

Maintaining tax fairness requires a constant monitoring of the tax system. Tax measures which were appropriate when introduced may no longer be suitable due to changes in the economy, new social priorities, aggressive tax planning and the need to improve compliance.

A portrait of the Canadian tax system follows with a particular focus on its many aspects that promote fairness. Highlights of the specific tax measures this government has introduced since 1994 to enhance fairness and information on steps taken in recent years to improve compliance are provided next. The last section summarizes measures in this budget to further increase the fairness of the Canadian tax system.

The Tax System and Fairness

Overview

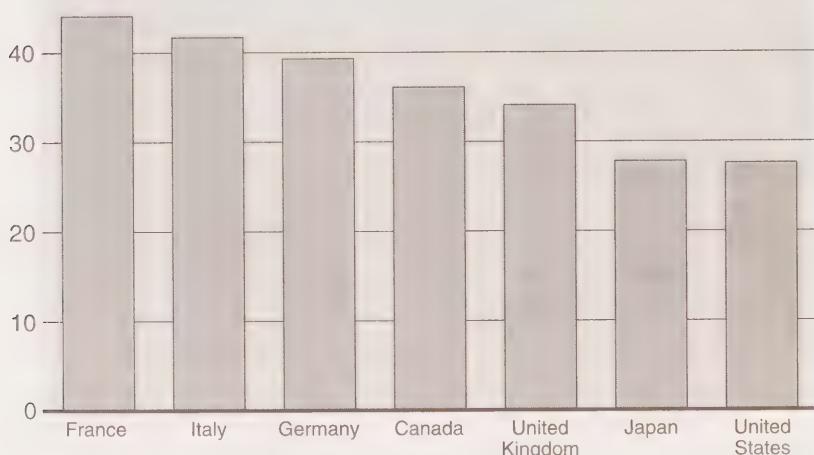
Total tax revenues for all levels of government in Canada stood at 36.1 per cent of gross domestic product (GDP) in 1994, the last year for which internationally comparable data are available. This puts Canada in the middle of the Group of Seven (G-7) large industrialized countries, but well above our major trading partners – the

Chart A5.1

Total tax revenue in G-7 countries: 1994

percentage of GDP

50



Source: OECD, *Revenue Statistics*, 1995.

United States, Japan and the United Kingdom (Chart A5.1). Taxes as a share of GDP in Canada rose in the 1980s and 1990s (Chart A5.2), although they peaked at 36.7 per cent in 1991 and have declined slightly since then.

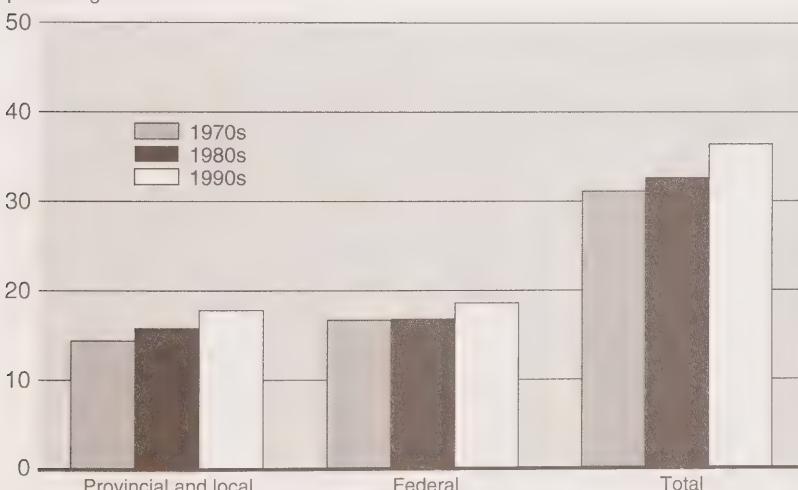
An efficient tax system should include taxes from several different sources. This ensures that the tax system has the flexibility to meet different policy goals and that no one tax source is relied on excessively.

In 1995-96, federal revenues totalled \$130.3 billion (16.8 per cent of GDP). Personal income tax is the most important source of revenue for the federal government followed by employment insurance (EI) contributions, sales taxes and corporate income tax (Chart A5.3). These are reviewed in the rest of the chapter with the exception of employee contributions to EI. These are linked with EI benefits, and the impact of benefits and contributions on fairness should thus be examined jointly. In this regard, studies show clearly that Canada's tax transfer system is highly progressive.

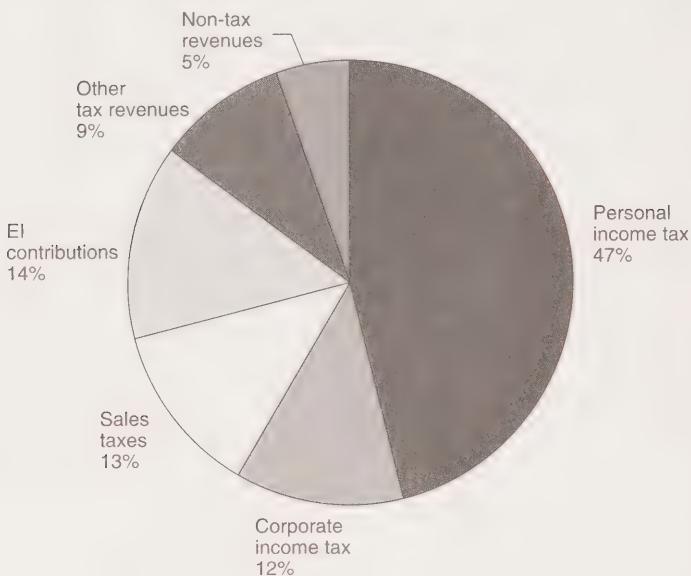
Chart A5.2

Revenues by level of government in Canada

percentage of GDP



Source: National Accounts.

Chart A5.3*Sources of federal revenues: 1995-96***Direct taxes on persons**

The personal income tax system is the largest source of revenue for Canadian governments. It is also the most important tool in the pursuit of the objective of tax fairness. There are three key principles that drive personal income tax:

- individuals with similar income and in similar circumstances should pay similar amounts of tax;
- special circumstances of taxpayers are recognized, so that two Canadians with similar incomes but different ability to pay because of particular needs, may pay different levels of taxes depending upon their particular needs; and
- the tax system is progressive. This means that the percentage of income paid in taxes increases with income.

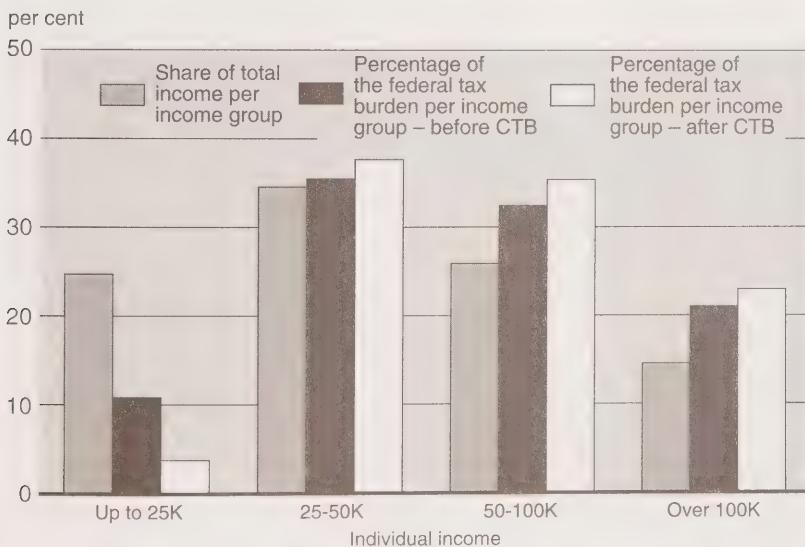
Comprehensive income is the basis for determining the ability to pay tax in the Canadian tax system. Income includes wages and salaries, self-employed earnings and capital income such as dividends, interest and capital gains. Some sources of income may not be fully taxed in order to achieve a variety of economic and social objectives. Certain transfers received by Canadians, such as social assistance and the guaranteed income supplement (GIS), are

excluded in defining taxable income. Deductions and tax credits are provided to recognize the influence of a number of factors on the ability to pay taxes. In some cases, credits at a federal rate of 17 per cent are used rather than deductions to ensure that high-income Canadians do not receive higher tax relief, reinforcing progressivity in the Canadian tax system. For example, credits are provided to cover the costs of medical expenses, education and disabilities. These features have the effect of eliminating tax liability for many low-income Canadians and significantly reducing the effective tax rates for other Canadians with modest incomes.

The three tax brackets – 17 per cent, 26 per cent and 29 per cent – and high-income surtaxes reflect the progressive nature of the Canadian tax system. Taking into account the various deductions and exemptions, average filers pay 18 per cent of their income in combined federal and provincial personal income tax, compared with a 23-per-cent average tax rate for filers with income between \$50,000 and \$100,000, and a 33-per-cent tax rate for filers with income above \$250,000. Chart A5.4 shows that Canadians at the high-income end pay substantially more taxes relative to their incomes than low-income Canadians.

Chart A5.4

Distribution of income tax burden by income level, 1994



The income tax system also has two refundable tax credits – the goods and services tax (GST) credit and the Child Tax Benefit (CTB) which includes the Working Income Supplement (WIS) directed to low-income working families – which reinforce progressivity by reducing or eliminating the tax burden on low- and middle-income Canadians. The CTB recognizes that the costs of raising children reduce the ability of modest- and middle-income families to pay tax. These credits are paid to eligible taxfilers even where there is no income tax liability. The WIS reduces work disincentives by providing an income supplement to families where a parent leaves social assistance to find employment. This offsets part of the employment-related expenses and the loss of social assistance benefits they incur. This means that the lowest-income Canadians actually receive assistance from the income tax system rather than paying taxes.

Why do some high-income individuals not pay any taxes at all?

High-income earners pay a large proportion of federal taxes. For example, in 1994, those with incomes above \$100,000 (about 2 per cent of filers) received 15 per cent of total income, but paid 21 per cent of total federal tax.

A few high-income earners may not pay income tax in a particular year by claiming legitimate deductions and credits. In 1994, for example, 290 individuals out of 54,000 taxfilers with incomes above \$250,000 did not pay tax in that year. Deductions and credits which are available to all taxpayers may result in the elimination of tax liability for some individuals. For example, a taxfiler earning a large income from one source may incur a loss from an unincorporated business, give a large charitable donation and save for his retirement, thus ending up paying no tax in a particular year.

It should be noted, however, that while an individual may be non-taxable in one year, this is not generally the case in preceding and subsequent years as non-taxability typically results from an unusual mix of circumstances.

In order to ensure that deductions and credits are not used abusively to eliminate tax liability, the alternative minimum tax (AMT) disallows some deductions and credits in the calculation of the tax. More than 27,000 taxpayers were subject to the AMT in 1994.

How much tax are low-income Canadians paying?

In 1994, individuals with incomes below \$25,000 represented about 60 per cent of all taxfilers, received about 25 per cent of total income and paid about 4 per cent of total federal tax, when Child Tax Benefit (CTB) payments are taken into account. In fact, many low-income Canadians actually receive money from the government through the tax system rather than paying taxes. About \$8 billion in federal assistance to low- and modest-income households is provided through the two federal refundable tax credits – the CTB (\$5.1 billion) and the GST credit (\$2.9 billion). To provide additional help to low-income working parents, the 1996 budget announced a \$250 million enrichment of the WIS, a component of the CTB, to take effect in two steps in 1997 and 1998.

Are family trusts being used to avoid the payment of taxes by the wealthy?

No. Family trusts are arrangements used to transfer property (for example, a family business or real property) to one or more members while trustees maintain control of the property. Trust arrangements are often used where beneficiaries are unable to manage the property for themselves, for example, because they are minors or disabled.

To ensure that all trust income is taxed appropriately, the 1995 budget eliminated an income-splitting opportunity by announcing the end of a measure that allowed undistributed trust income to be taxed in the hands of beneficiaries, except in the case of beneficiaries who are mentally or physically impaired. The 1995 budget also cancelled provisions which allowed trusts to defer paying taxes on capital gains for long periods of time. As a result, tax advantages associated with family trusts have been eliminated.

The income of trusts paid out to beneficiaries is taxed in their hands. The undistributed income of trusts, except for trusts created under an individual's will on death (testamentary), is taxed at the highest federal income tax rate of 29 per cent (provincial taxes are on top), rather than at the graduated tax rates at which individuals are taxed. This means that non-testamentary trusts pay a higher proportion of their incomes in taxes than do individual taxpayers.

Why does the federal government not have a wealth tax to enhance fairness?

Even though Canada does not have either an annual net wealth tax or a wealth transfer tax, taxes on wealth holders (e.g., municipal property taxes, corporate capital taxes) were higher as a per cent of GDP than in any other OECD country in 1994.

High-income taxpayers already pay substantial taxes. In 1994, individuals with over \$100,000 in income represented just over 2 per cent of tax filers, received 15 per cent of total income, but paid 21 per cent of income taxes.

To prevent the tax-free transfer of income between generations, the government also taxes all unrealized capital gains at death, except when they are transferred to a spouse.

A wealth tax would simply add to the already high effective tax rates on investment returns.

Since 1994, the government has sought to ensure high-income earners shoulder their fair share of deficit reduction. Measures introduced include:

- eliminating the \$100,000 lifetime capital gains exemption;
- eliminating inappropriate tax advantages that flow from establishing family trusts;
- reducing registered pension plan and registered retirement savings plan limits; and
- restricting inappropriate opportunities to defer taxes.

Sales tax

The second major type of tax on individuals is sales tax. This tax is linked to the amount of consumption, in contrast to income tax which is linked to the amount of income. As argued above, such diversification of the tax base is important for a number of reasons.

With respect to the GST, tax fairness is accomplished primarily through the income-tested refundable GST credit, worth \$2.8 billion in 1994. By providing direct payments to families and individuals at low- and modest-income levels, and reducing these payments as income rises, the refundable GST credit helps offset the sales tax burden of lower-income families and individuals, thereby ensuring that sales tax burdens are sensitive to differences in income and family type.

Another instrument for addressing fairness in sales tax burdens is to exempt from taxation some commodities that are more heavily consumed by low-income individuals. Key examples are the tax-free treatment of basic groceries and prescription drugs, and the exemption of residential rents from the GST.

The GST also includes a system for rebating a portion of tax paid by municipalities, universities, schools and hospitals, as well as qualifying non-profit organizations and charities. GST rebates to these sectors help ensure that the cost of the important public services they provide is not unduly affected by sales taxes. The federal government has recently expanded these rebates to effectively lift all the GST from books purchased by schools, universities, libraries and other literacy-promoting organizations. The 100-per-cent GST rebate on books recognizes the instrumental role played by these institutions in helping individuals gain access to the tools they need to learn to read or pursue their education.

Does the GST impose an unfair burden on low-income Canadians?

No. The refundable low-income GST credit, worth \$2.8 billion in 1994, significantly reduces the GST burden faced by low-income Canadians. For example, in 1994, over six million families and low-income singles with incomes below \$20,000 received, on average, \$320 under the refundable GST credit. Furthermore, the tax-free treatment of major consumption items such as basic groceries and prescription drugs ensures that these expenditures are not taxed at all, while the exemption of residential rents provides further sales tax relief. These three areas of expenditures are most important for low-income Canadians.

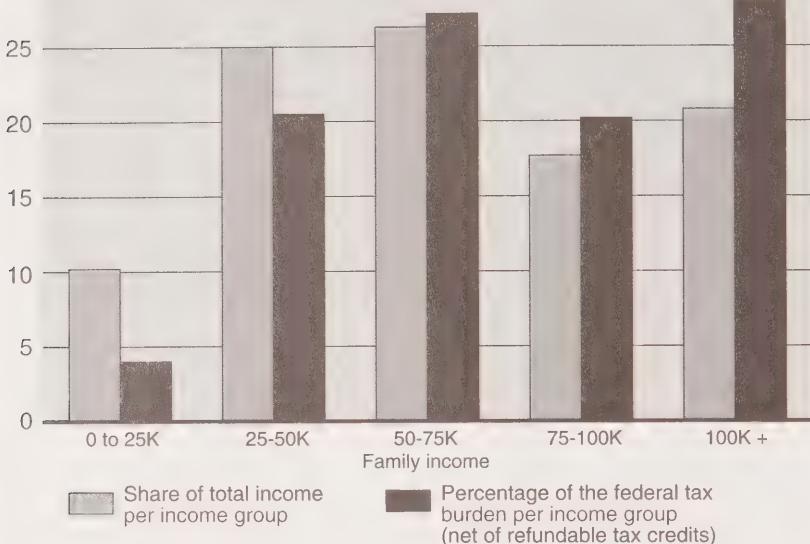
Chart A5.5 combines the incidence of income and sales taxes to determine the extent to which the federal tax system is progressive for Canadian families. Chart A5.5 confirms the conclusion drawn from Chart A5.4 on income tax alone: Canadian families at the high-income end pay considerably more taxes relative to their incomes, which is in accordance with the principles of fair taxation.

Chart A5.5

Incidence of federal income and sales tax by family income level, 1996

per cent

30

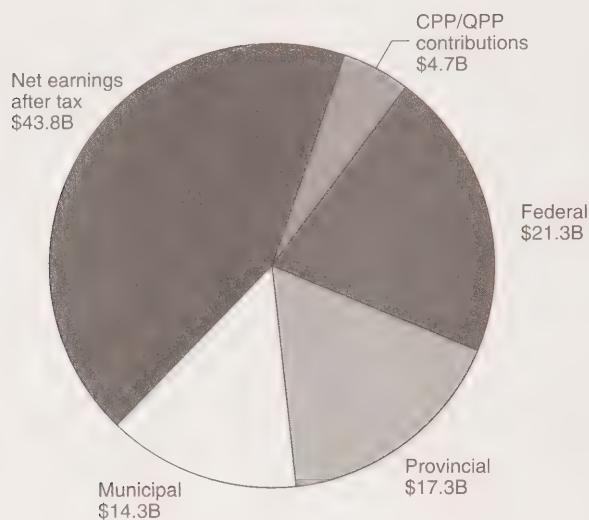
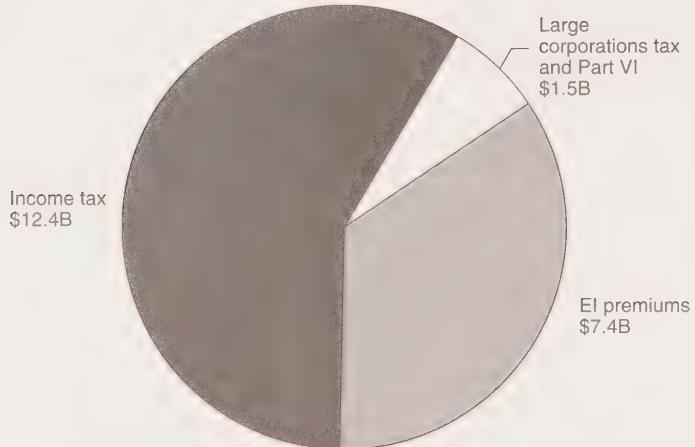
**Taxes on business**

A key element of a fair tax system is that corporations should pay their fair share of tax. Some have argued that corporations should not pay taxes at all since, sooner or later, corporate income ends up in the hands of individuals and is taxed under personal income tax. This view is inaccurate and corporations should pay tax for three key reasons. First, businesses benefit from public services in many of the same ways that individuals do. Second, in the absence of tax on corporations, it would be possible for individuals to postpone tax on income or capital gains indefinitely by placing income-producing assets in a corporation and thereby having the income or gains accrue within the corporation. Corporate income tax addresses this problem by imposing a tax on profits and capital gains prior to their distribution to individuals in the form of dividends. Third, corporate taxes allow the taxation of income accruing to foreigners and ensure that foreign-based corporations operating in Canada pay tax on income earned in Canada.

Capital taxes are used by both federal and provincial governments to supplement income tax revenues and to ensure that corporations pay for the public services they use. For example, the federal large corporation tax (LCT) ensures that all large corporations pay tax. Similarly, provincial capital taxes are an important source of revenue in some provinces. Capital taxes can also serve as a form of minimum tax as is the case for the federal capital tax on financial institutions where large banks, trusts and life insurance companies have to pay a minimum amount of tax based on capital which can then be offset by federal income tax. Overall, these capital taxes generated \$1.5 billion in federal revenues in 1995.

Corporations pay a variety of other taxes and contributions in addition to income and capital taxes. These include payroll taxes (in respect of employers' contributions to EI, Canada/Quebec Pension Plans (CPP/QPP) and Workers' Compensation), property taxes, and indirect taxes such as sales and excise taxes. Excluding indirect taxes – for example, fuel taxes – corporations paid about \$57 billion in total taxes and levies to federal, provincial and municipal governments in 1995. Chart A5.6 illustrates the breakdown of net earnings by corporations and Chart A5.7 illustrates the breakdown of the federal component of corporate taxes. Over the last three decades, corporations have paid an average of 36 per cent of their pre-tax profits in income and capital tax.

Corporate income tax receipts vary cyclically with the level of profits in the economy. Over the last few years, corporate income taxes have experienced the fastest rate of growth of all federal revenue sources, reflecting their sensitivity to stronger economic growth experienced over this period. Between 1988-89 and 1991-92, federal corporate income and capital taxes declined from \$12 billion to less than \$10 billion. They have since risen to \$16 billion in 1995-96.

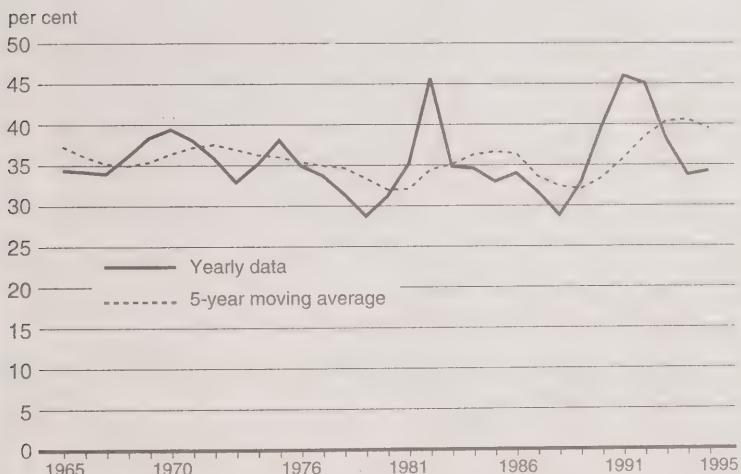
Chart A5.6*Corporate earnings ... who gets what – 1995***Chart A5.7***Corporate taxes: federal mix – 1995*

Has the tax burden on corporations been reduced in recent years?

Comparison of the ratio of corporate income taxes to total government revenues or to GDP can create the misperception that the total tax burden on corporations is falling. The major reason these ratios fell, particularly in the early 1990s, is that corporate profits have fallen as a percentage of Canada's GDP. In fact, the corporate income and capital tax burden has not declined. It has ranged, on average, between 32 to 41 per cent of pre-tax earnings since 1965.

In addition to corporate income and capital taxes, businesses pay a wide variety of other taxes such as employers' payroll taxes and property taxes. All the direct taxes paid by corporations amounted to more than \$57 billion in 1995. Over the years, payroll taxes paid by employers for EI, CPP/QPP, Workers' Compensation and other provincial payroll taxes increased significantly from 1.4 per cent of total payroll in 1961 to 7.8 per cent in 1993.

Corporate income and capital taxes as a per cent of pre-tax profits: 1965-95



Are payroll taxes too high in Canada?

The total payroll tax burden in Canada is lower than in other countries, including the U.S. Of the G-7 countries, Canada and the U.K. have the lowest level of payroll taxes as a proportion of GDP. Total payroll taxes paid by employers and employees are lower in Canada than in the U.S. at all levels of employee income. This could be an important factor in a firm's decision to locate its production facilities in Canada or the U.S.

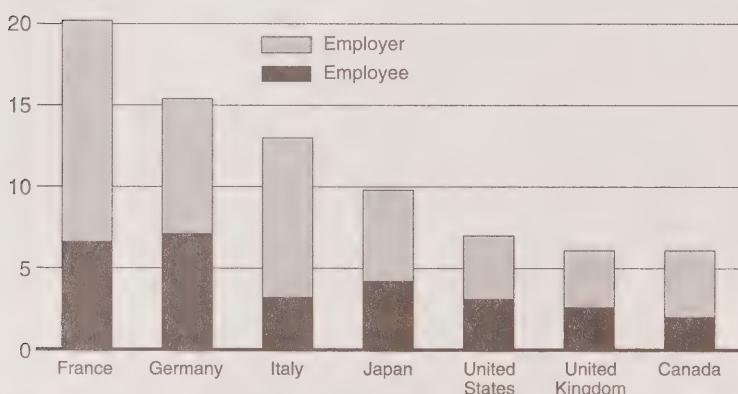
Most studies show that it is not the level of these taxes that has an adverse effect on job creation but rather the increase in the payroll tax rate, particularly during a recession. The government has lowered the tax rate on employees under EI from \$3.07 to \$2.90 per \$100 of their maximum insurable earnings (MIE) and from \$4.30 to \$4.06 for employers. The decline in MIE itself has also lowered the payroll tax burden. The decline in the payroll tax has not been more rapid because of the constraints imposed by the fiscal situation.

In addition, almost 900,000 firms in Canada will be eligible for EI premium relief under the New Hires Program. This means almost all eligible firms will pay virtually no premiums for new employees hired in 1997, and will benefit from a 25-per-cent reduction in premiums for new employees the following year. The maximum benefit per firm will be \$10,000 in each year.

*Payroll taxes as a per cent of GDP
G-7 countries, 1994*

per cent

25



Measures to Enhance Fairness in the Last Three Budgets

The government has undertaken a large number of actions to improve tax fairness in the last three budgets. Table A5.1 provides a convenient summary of the most important of these measures. All major tax areas were changed including personal income tax, business income tax and sales tax. In all, Table A5.1 lists 35 major actions. In addition to these changes, the government has made or announced a number of other changes to the tax system since 1994 in budgets, technical bills and press releases to achieve a variety of objectives. A full listing of these other tax changes is provided in the Appendix. Many of these changes, although not major, also improved the fairness of the tax system.

The focus on the personal income tax side has been twofold: to ensure that those Canadians who are better off pay their fair share of taxes; and to provide additional tax assistance to those Canadians who can least afford to pay taxes. Key steps on the former included the elimination of the \$100,000 lifetime capital gains exemption (LCGE), elimination of tax advantages available through family trusts, and the expansion of the base for the alternative minimum tax (AMT). On the latter, the main areas of action were greater tax assistance for education, children, charities and persons with disabilities.

On the business income tax side, the main objective has been to close down unintended tax loopholes and to ensure that corporations make a reasonable contribution to help deal with the federal government's fiscal problem. Major steps included tightening in a number of areas, including the reduction of possibilities to defer tax, and increases to the LCT and the corporate surtax. In total, these measures are now generating more than \$1 billion in additional tax revenue each year.

New rules on taxpayer migration were recently announced. These rules will ensure that taxes on gains accrued in Canada are indeed paid to Canada.

Canada is also participating in initiatives of the Organization for Economic Co-operation and Development (OECD) to devise co-ordinated responses to international tax avoidance through tax havens.

Modest but important steps were also taken in the sales tax field to reduce the tax burden on the disabled, the sick and charitable and public sector organizations, thus eliminating the need to pay sales tax on many essential items of purchase. The government has also provided a 100-per-cent GST rebate on all books purchased by public libraries, schools, universities, public colleges, municipalities and qualifying charities and non-profit organizations.

Table A5.1

*Measures to enhance the fairness of the tax system since 1994
(year of introduction shown in parentheses)*

Ability to pay: personal income tax

- eliminated the \$100,000 lifetime capital gains exemption (LCGE). (1994)
- extended the base for the alternative minimum tax (AMT). (1994)
- eliminated tax advantages available through trusts. (1995)
- restricted the use of tax shelters. (1994)
- introduced new rules on taxpayer migration to ensure that gains that accrue while a taxpayer is a resident of Canada are subject to Canadian tax. (1996)
- extended the taxation of employer-paid life insurance premiums to the first \$25,000 of coverage. (1994)
- reduced the overcontribution allowance for registered retirement savings plans (RRSPs) from \$8,000 to \$2,000. (1995)
- reduced the RRSP and money purchase registered pension plan (RPP) dollar limits to \$13,500 in 1996 and froze them through 2003 and 2002 respectively. (1995, 1996)
- froze the maximum pension limit for defined benefit RPPs at \$1,722 per year of service until 2005 (only affecting individuals earning over \$75,000). (1996)
- eliminated the retiring allowance rollovers for years of service after 1995. (1995)
- introduced income-testing of age credit. (1994)
- reduced the maximum age limit for deferring tax on savings in RRSPs and RPPs from 71 to 69. (1996)

Table A5.1 (cont'd)

Measures to enhance the fairness of the tax system since 1994
(year of introduction shown in parentheses)

Ability to pay: business income tax

- increased the large corporation tax (LCT) and corporate surtax. (1995)
- introduced temporary surcharge on banks and other large deposit-taking institutions. (1995)
- eliminated the small business deduction for large private corporations. (1994)
- reduced the deduction for business meals and entertainment expenses from 80 to 50 per cent to better reflect the personal consumption element of these expenditures. (1994)
- increased the rate of tax on corporate dividends received by private investment corporations. (1994)
- taken steps to ensure that the income of financial institutions is measured appropriately for tax purposes. (1994)
- eliminated the deferral of tax on unincorporated business income. (1995)
- eliminated the deferral advantage for investment income earned by private holding companies. (1995)

Special help for those in need: personal income tax

- introduced new tax treatment of child support payments with payments non-deductible for the payer and non-taxable for the recipient. (1996)
- announced two-step enrichment of the Working Income Supplement (WIS) of the Child Tax Benefit (CTB) of \$250 million. (1996)
- proposed new Seniors Benefit, which is more progressive, fully indexed and tax-free, will replace old age security (OAS) and the guaranteed income supplement (GIS) in 2001. (1996)
- replaced the seven-year limit by an unlimited carry-forward of unused RRSP room. (1996)
- enriched the infirm-dependant tax credit. (1996)
- lowered the threshold at which charitable donations begin to earn the 29-per-cent tax credit from \$250 to \$200. (1994)
- increased the limits on charitable donations eligible for tax credits from 20 to 50 per cent of net income, and to 100 per cent of net income in the year of death and the preceding year. (1996)
- increased the education amount from \$80 to \$100 per month. (1996)

Table A5.1 (cont'd)

Measures to enhance the fairness of the tax system since 1994
(year of introduction shown in parentheses)

Special help for those in need: personal income tax (cont'd)

- raised the annual limit on the transfer of the tuition fee and education amounts to those who support students from \$4000 to \$5000. (1996)
- increased the annual limit on contributions to registered education savings plans (RESPs) from \$1500 to \$2000, and the lifetime limit from \$31,500 to \$42,000. (1996)
- broadened eligibility for the child care expense deduction to assist parents who undertake education or retraining. (1996)

Special help for those in need: sales tax

- proposed expanding zero-rating to persons with disability to purchase orthopaedic and orthotic devices. (1996)
- proposed expanding zero-rating of hospital beds to all health care facilities, including long-term care facilities. (1996)
- proposed most charitable and public organizations raise funds without collecting and remitting GST on sales. (1996)
- proposed 100-per-cent GST rebate on books purchased by public libraries, educational institutions and other specified bodies. (1996)

Taxes Owed are Indeed Paid: Measures in Recent Years

Canada's tax system is based on the principle of self-assessment in which Canadians assess their own taxes by filing tax returns with Revenue Canada, pay any taxes due and, of course, receive as a refund any funds due to them.

Revenue Canada's strategy to obtain compliance with the tax laws is based on voluntary compliance. Compliance is achieved through a balance of assistance, education and service activities along with responsible enforcement.

Revenue Canada has taken a number of initiatives to simplify tax administration, including outreach programs, improved telephone information systems and ongoing liaison with special taxfiler groups such as seniors and industry associations. By facilitating compliance, these initiatives help recover tax revenues. Details of these measures can be found in Table A5.2.

The system works well. The vast majority of Canadians comply fully with the law. However, as in any tax system, there are instances where taxes are not paid or not paid on time.

Tax law is complex and every effort must be made to simplify the system for those who may not have access to professional advice. There may be those who have experienced circumstances beyond their control preventing them from paying on time. Others may have no financial means to pay due to a pending bankruptcy. Also, there are those who avoid or evade taxes.

Different actions are required to recover taxes in these different situations. Table A5.2 also provides a summary of the most recent actions taken in this area. Chart A5.8 shows that Revenue Canada's verification and enforcement activities resulted in \$4.8 billion in additional reassessments in 1995-96, a 25-per-cent increase over four years.

Tax evasion is the most serious aspect of non-compliance. It is the deliberate action of illegally hiding or underreporting income or inflating deductions or expenses.

Chart A5.8

Results of enforcement and verification programs in 1995-96

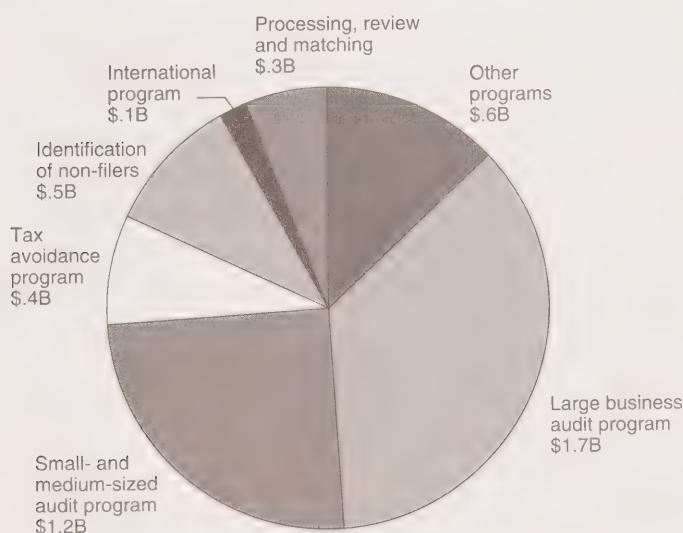


Table A5.2*Measures to enhance the effectiveness of tax collection***Simplifying tax administration for Canadians**

- strengthened outreach and education programs.
- enhanced easy-to-understand automatic telephone information systems.
- provide advice to taxpayers who need it.
- meet with special taxfiler groups such as senior citizens and immigrants to help them comply.

Simplifying tax administration for business

- established a single Business Number for streamlining registration for GST remitters, employers, corporations and importers/exporters.
- new “Business Window” initiative to provide one-stop service, especially beneficial for small businesses.
- simplified payroll reporting for small businesses.
- reduced compliance costs for small- and medium-sized businesses by co-ordinating GST, income tax and excise tax audits.
- streamlined procedures to simplify and expedite customs clearance.

Improved enforcement

- implemented a new approach to large business audits including audit protocol.
- reinforced measures to target the underground economy.
- earlier identification of abusive tax avoidance and tax shelter schemes.
- continued improvement of sophisticated risk models to identify areas of high risk and a sector approach to compliance for small- and medium-sized businesses.
- forgiveness of penalties on voluntary tax disclosures to encourage taxpayers to comply voluntarily.
- agreements with many countries for exchange of information to help deal with tax havens.
- new rules requiring residents of Canada to file an information return when they own foreign assets in excess of \$100,000 in value.

Revenue Canada, together with provincial authorities, have focused on a number of sectors of the economy where the risk of tax evasion is high, including construction, jewellery sales, auto repairs, home repairs, hospitality and other services. Sector-specific strategies have been developed such as the new reporting system for the construction industry. Revenue Canada also deals with tax evasion through criminal investigation programs. In 1995-96, special investigations reviewed over 28,000 referrals from external sources.

The government implemented an anti-smuggling initiative which has resulted in the seizure of contraband, such as drugs, tobacco, alcohol and firearms valued at more than \$2 billion.

A particular area of government focus has been international tax havens. Tax recoveries on international transactions have tripled since 1992-93. Resources for international audit and verification will be tripled by 1998 compared to 1993 and Canada will strengthen its exchange of information with its tax treaty partners to ensure full reporting of foreign income.

New Budget Measures

This budget continues the task of improving fairness by providing additional tax assistance in a number of areas of priority:

- assisting students to defray the costs of education, helping workers to enhance their skills, and helping parents save for their children's education;
- helping children by providing significant additional funds towards an enriched and simplified National Child Benefit System as a step towards a more level playing field between families receiving social assistance and low-income working families;
- assisting people with disabilities to participate more fully in society by increasing tax assistance for disability-related costs and reducing disincentives to work;
- helping charities to raise donations by enhancing tax incentives to donors; and

■ updating Canadian rules on transfer pricing to bring Canadian law and practices in line with the evolving international standard to improve taxpayer compliance and to facilitate audits by Revenue Canada. These changes will preserve the fairness of Canada's tax system by ensuring that profits earned by taxpayers in connection with international transactions with non-resident related parties are properly measured and taxed in Canada.

Table A5.3 summarizes the new measures proposed in this budget.

Table A5.3

New budget measures to enhance the fairness of the tax system

Higher and more flexible tax assistance to students

- double the basis for the education credit over two years to \$200 per month.
- make ancillary fees eligible for the tuition credit.
- allow a carry-forward of unused tuition and education credits.
- increase annual contribution limits for registered education savings plans (RESPs) from \$2,000 to \$4,000.
- allow transfers of RESP funds to a registered retirement savings plan (RRSP) or to the contributor.

Move towards a National Child Benefit System

- proposing a \$6 billion Canada Child Tax Benefit by simplifying and enriching the current Child Tax Benefit, starting July 1998.
- enrichment of the Working Income Supplement (WIS) in July 1997 from the \$125 million announced in the 1996 budget to \$195 million and restructuring from a per-family to a per-child basis.

Additional tax assistance for people with disabilities

- broaden the medical expense tax credit.
- remove the limit on the attendant care deduction.
- introduce a refundable medical expense credit for earners.
- broaden the definition of preferred beneficiary for trusts benefiting people with disabilities.

Table A5.3 (cont'd)*New budget measures to enhance the fairness of the tax system***Increase tax assistance for charitable donations**

- reduce the inclusion rate on capital gains arising from the donation of publicly listed securities from 75 to 37.5 per cent.
- change the income limit for donations to 75 per cent.
- include 25 per cent of capital cost allowance (CCA) recapture in the net income limit.
- introduce a new method of valuation for easements of ecologically sensitive lands.
- increase resources for Revenue Canada to enhance information and compliance.

Transfer pricing

- update Canadian rules.
- require adequate documentation of transactions and introduce new penalty provisions related to Revenue Canada reassessments.
- increased resources for Revenue Canada for transfer pricing audits.

Appendix

Other changes to personal income tax expenditures

1994

- continued Home Buyers' Plan for first-time home buyers only.

1995

- exempted donations of ecologically sensitive land from the 20-per-cent limit.
- required non-resident recipients of OAS benefits to report their world income for purposes of the OAS high-income clawback.
- increased the rate of interest charged on income tax arrears.
- eliminated double claims of personal credits in year of personal bankruptcy.
- expanded taxation of non-residents' gains on Canadian capital property.

1996

- reduced the tax credit in respect of LSVCCs as well as the maximum purchase eligible for the credit. Increased the minimum holding period with respect to the credit. Denied eligibility for the credit for three years following the redemption of an LSVCC share.
- eliminated the administrative fee deduction for registered retirement income funds (RRIFs) and RRSPs.
- limited the withholding tax relief available to non-resident recipients of Canadian pension income.
- tightened rules governing the overseas employment tax credit.

Recent changes to corporate income tax expenditures

1994

- introduced a temporary 40-per-cent surcharge on tobacco manufacturing profits.
- lowered tax rate for manufacturing and processing – one percentage point reduction in the tax rate from 22 to 21 per cent.
- phased out access to refundable scientific research and experimental development (SR&ED) tax credits for larger private corporations having taxable capital between \$10 and \$15 million.
- eliminated the 30-per-cent special investment tax credit and the 30-per-cent Atlantic SR&ED credit.
- reduced the Atlantic Canada investment tax credit from 15 to 10 per cent.
- eliminated the accelerated depreciation for air and water pollution abatement equipment effective 1999.
- reduced the accelerated depreciation rate for energy conservation equipment from 50 per cent straight-line to 30 per cent declining balance.
- tightened the rules applicable on forgiveness of debt.
- eliminated the use of “purchase butterflies” as a method to avoid tax on dispositions of appreciated corporate property.
- increased the refundable tax on dividends received by private corporations (Part IV tax).
- eliminated the special preference for sole-purpose SR&ED performers.
- constrained certain tax shelter schemes that had been developed utilizing convertible debt and negative adjusted cost bases.
- required property and casualty insurers to fully discount unpaid claims.
- modified the basis upon which insurance companies may claim reserves for income tax purposes.
- introduced a rule providing a deadline for making SR&ED claims.
- eliminated tax benefits for limited recourse financings, applied the minimum tax to all tax shelter deductions, and increased penalties for selling unregistered tax shelters (December 1, 1994 release).

1995

- replaced film tax shelter mechanism with an investment tax credit.
- tightened the rules relating to non-arm's-length contract SR&ED, non-arm's-length provision of goods and services for SR&ED and certain third-party payments.
- announced rules strengthening the ability of Revenue Canada to obtain information.
- announced rules preventing the avoidance of source deduction remittances.
- eliminated the preferred beneficiary election for most beneficiaries.
- improved rules preventing artificial or premature recognition of tax losses.
- introduced rules preventing capital costs being converted into up-front expenses by prepaying rent.
- expanded taxation of non-residents' gains on Canadian capital property.

1996

- tightened the resource allowance rules to provide a more consistent and stable resource allowance calculation and eliminated uncertainties related to court decisions.
- tightened flow-through shares (FTS) to better focus the incentive – ensured that FTS are used to finance the more risky expenditures such as exploration and development costs and not property-related costs.
- reduced the threshold levels and introduced a new restriction on reclassifications of expenses by oil and gas companies using FTS to better target this incentive to junior companies in start-up situations.
- excluded off-the-shelf seismic costs as eligible costs for FTS. Modified rules for accelerated CCA for mining activities – companies can earn accelerated CCA when they undertake large capital expenditures (i.e. above 5 per cent of gross revenues). In addition, oil sands projects using *in situ* extraction processes will also be eligible for accelerated allowances.

- enhanced incentives to invest in renewable energy – relaxed the specified energy property rules and expanded eligibility for FTS.
- extended the capital tax surcharge on large deposit-taking institutions by one year.
- announced pending changes to the taxation of life insurance companies and a three-year extension of additional capital tax in life insurance to take effect in 1996.
- limited amount of wages and salaries eligible for SR&ED tax credits for specified employees.
- terminated transitional provision for certain building rental payments in respect of SR&ED.
- determined the ordinary tax rate of non-residents for withholding tax purposes by reference to the greater of Canadian and worldwide income.
- repealed joint exploration corporation rules.
- tax shelter rules concerning mismatched expenses and revenues announced November 18, 1996.

Recent changes to GST

- measures to simplify the operation of the tax for many businesses, charities and non-profit organizations.
- measures to improve the fairness of the GST for businesses and consumers.
- clarifications and measures to ease compliance.

Annex 6

Tax Measures: Supplementary Information and Notices of Ways and Means Motions

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Tax Measures: Supplementary Information

Overview

This budget proposes a number of measures to provide selective increases to tax assistance for those most in need. The government is targeting additional tax relief to children in low-income families, to students and their parents, to persons with disabilities and to help charitable organizations in raising funds. There are also measures to help small businesses and improve the retirement income system.

The budget also proposes a number of measures designed to improve the effectiveness of the business income tax system and promote fairness. To help maintain revenues, the budget proposes extending the temporary tax on the largest deposit-taking institutions, and a number of other measures to prevent the loss of corporate and excise tax revenues.

Table A6.1
Federal revenue impact of new tax measures

	1997-98	1998-99	1999-2000
(millions of dollars)			
Personal income tax measures			
Enhance tax assistance to education and training			
Increase education credit	-5	-45	-80
Make ancillary fees eligible for the tuition credit	-5	-30	-30
Allow a carry-forward of unused tuition and education credits	—	-10	-25
Increase RESP annual limit to \$4,000 and allow transfers to RRSPs or to contributor	-10	-25	-40
Helping small businesses			
Quarterly remittance of withholdings	-180	-5	-5
Enhancing effectiveness of LSVCCs	—	—	—
Improving the retirement income system			
PAR: restoring lost RRSP room	—	—	—
Averaging of CPP/QPP lump sum payments	small	small	small
Towards a National Child Benefit System			
Enrichment and restructuring of the Child Tax Benefit	-50	-470	-600
Measures to assist Canadians with disabilities			
Broadening the medical expense tax credit; removing limit on attendant care deduction	-5	-30	-30
Refundable medical expense supplement for earners	-5	-30	-40
Measures to enhance tax assistance to charitable giving			
Reduce the inclusion rate on capital gains arising from the donation of publicly listed securities from 75% to 37.5%	-20	-90	-90
75% net income limit for all donations; include 25% of CCA recapture in the net income limit	—	-5	-5
New method of valuation for easements of ecologically sensitive lands	—	—	—
Increased resources for Revenue Canada	-5	-5	-5
Subtotal	-285	-745	-950
Business taxation measures			
Review of transfer pricing rules		prevents revenue losses	
Restricting investment tax credit claims		prevents revenue losses	
Extension of temporary tax on large deposit-taking institutions	25	45	—
Environmental initiatives	—	-25	-25
Sales and excise tax measures			
Clarify measurement of fuel volumes	—	—	—
Total	-260	-725	-975

Tax assistance for education and training

Increasingly, achieving higher education and continuously updating skills are essential to securing a prosperous future for Canadians. Tax assistance to students and those supporting them helps Canadians meet these challenges. The tax system also encourages parents to save for their children's education.

Helping students and those who support them

At present, the following tax relief is available to students in Canada:

- a credit in respect of tuition fees;
- an education credit based on an amount of \$100 (increased from \$80 for 1996) for each month in which an individual is enrolled as a full-time student; and
- an exemption of \$500 for scholarship, fellowship or bursary income.

In order to provide additional assistance to students to help defray the costs of higher education, the budget proposes to double the education amount, from \$100 to \$200 per month of full-time study. The education amount will rise to \$150 in 1997 and reach \$200 for 1998 and subsequent years. This significant increase in the education credit since 1995 will benefit roughly one million students.

Fees eligible for the tuition credit include the basic costs of instruction as well as charges, for example, for library or laboratory facilities and mandatory computer service fees. Increasingly, universities are also relying on ancillary fees which are imposed on all students. These include fees for health services, athletics and various other services. The budget proposes to extend the tuition tax credit to cover mandatory ancillary fees imposed by universities, colleges and other post-secondary institutions to cover the cost of education. This extension will not apply to student association fees, ancillary fees at institutions certified by the Minister of Human Resources Development and, as with the current tuition credit, will not cover goods of enduring value that are retained by students.

At present, if a student has insufficient income to take full advantage of the education or tuition amounts, the unused portion may be transferred to a supporting spouse, parent or grandparent. The sum of the amounts transferred and used by the student is subject

to a limit of \$5,000 (increased from \$4,000 for 1996). This transfer recognizes that some students are not in a taxable position and are supported by their family.

While the tuition and education credits may only be claimed in the taxation year to which they relate, most students are able to use them fully or transfer them to a supporting individual. However, some students are unable to use these credits fully, either because they have low incomes, relatively high tuition fees, no supporting individual, or supporting individuals who themselves have low incomes in the year. In the case of workers taking upgrading courses or returning to studies after a period in the workforce, there may be no supporting individual with sufficient taxable income in that year to benefit from a transfer. To permit all students to take full advantage of the tuition and education credits, the budget proposes to allow the student to carry forward these credits indefinitely until they have sufficient tax liability to make use of them.

The carry-forward will apply with respect to tuition and education amounts earned in 1997 and subsequent taxation years. Any amounts not used by the student, and not transferred to a supporting individual, will be automatically carried forward for future use by the student. The unused amounts transferred to a supporting individual cannot exceed the total tuition and education amounts arising in that year, and will continue to be limited to \$5,000 per year. However, amounts carried forward will be available for the student's own use in any subsequent year. Students will be required to provide the necessary information to establish a carry-forward. Revenue Canada will keep track of a student's unused amounts and report them on the student's notice of assessment.

These measures are effective starting with the 1997 taxation year.

Encouraging savings for education through registered education savings plans (RESPs)

Registered education savings plans provide a vehicle for individuals to accumulate income for post-secondary education. Under these plans, individuals make contributions which are held in trusts in order to generate income to be used to finance the post-secondary education costs of the beneficiaries under the plan. In practice, most contributors are parents saving for their children's education. Contributions to registered education savings plans (RESPs) are not deductible from the income of the contributor, and normally return to the contributor

tax free. However, the income generated by the contributions is tax sheltered until paid out to named beneficiaries, when it is taxed in the beneficiaries' hands. Since students typically have little income, they pay little or no tax on the RESP-sheltered income.

To ensure that the amount of the tax-assisted savings sheltered by an RESP bears a reasonable relationship to the costs of post-secondary education, there is an overall lifetime limit of \$42,000 per beneficiary. To encourage regular savings for education over a long period, there is an annual limit of \$2,000 on contributions in respect of a beneficiary. These limits represent a 33-per-cent increase over the levels in place prior to the 1996 budget. All registered plans must be wound up after 25 years.

In light of rising tuition costs, and the need to encourage additional savings for post-secondary education, the budget proposes to increase the limit on annual RESP contributions from \$2,000 to \$4,000. This increase in the annual limit will give taxpayers significantly more flexibility in the timing of their contributions to a plan – e.g., by allowing them to make up for missed contributions. It also recognizes that many taxpayers are not in a position to set money aside for their children's education when the children are very young, and therefore need to contribute more in later years. This provision may also be beneficial to immigrants with children who were unable to use RESPs when their children were very young.

Because the purpose of an RESP is to help post-secondary students, if a contributor's named beneficiary does not pursue higher education, the income from the RESP must go either to another eligible student or to an educational institution. In particular, RESP income is not available to the contributor unless the contributor is the named beneficiary of the plan and is enrolled in post-secondary education.

Parents and others who consider setting up an RESP for a child are sometimes dissuaded by the risk that their investment income will be forfeited if their child does not go on to post-secondary education. To reduce the risk that RESP income will be directed beyond the wishes of the contributor, the budget proposes to allow contributors to receive RESP income directly under certain circumstances.

If all intended beneficiaries are not pursuing higher education by age 21, and the plan has been running for at least 10 years, a contributor resident in Canada will generally be allowed to withdraw the income from the plan. The contributor will be allowed to transfer RESP income to a registered retirement savings plan (RRSP)

under which the contributor (or the contributor's spouse) is the annuitant, without penalty, if the contributor is able to claim RRSP deductions for the year of the transfer equal to at least the amount of the transferred RESP income. To the extent that RESP income is not fully offset by RRSP deductions, a charge of 20 per cent will apply in addition to regular taxes for the receipt of the RESP income. This charge is necessary to ensure that tax assistance is not provided for those who might use RESPs for tax-deferral purposes unrelated to either education or retirement savings. Further to this objective, the total amount of RESP income which a contributor may transfer to an RRSP during his or her lifetime will be limited to \$40,000. Although a subscriber may direct that the principal from a plan be returned to another individual on a tax-free basis, income which is not an educational assistance payment will be considered income of the subscriber for tax purposes.

At present, RESP beneficiaries are not eligible to receive educational assistance payments from the plan if they are taking distance education courses, such as correspondence courses. The budget proposes to change this provision so that full-time students enrolled in a qualifying educational program at an eligible institution will become eligible for educational assistance payments.

The *Income Tax Act* permits a contributor to set up a "family plan", in which each of the plan's beneficiaries is related to the contributor by blood or adoption. Family plans, which are typically established for several siblings under age 18, are subject to the same contribution limits per beneficiary, but provide additional flexibility for the contributor because education assistance payments need not be limited by each child's "share" of the contributions. This allows a contributor with three beneficiaries, for example, to direct the entire income to the two children pursuing education if the third child is not eligible. At present, many group plans are structured in a way that prevents a child who may pursue higher education from benefiting from income accumulated in respect of a sibling who will not be pursuing education. The budget proposes to allow other siblings to benefit from this accumulated income by preventing the RESP overcontribution penalty from applying to transfers of this sort within group plans.

In light of these new measures, Revenue Canada will require additional information from RESP trustees, primarily in relation to the number of active plans in place and the funds accumulating in those plans.

The measures involving the annual limits, distance education and RESP contributions for a family are effective starting with the 1997 taxation year. The provisions regarding the return of RESP income to the contributor, and additional information requirements, will apply after 1997.

More details on these proposals, together with information on changes of a technical nature, are provided in the accompanying Notice of Ways and Means Motion to amend the *Income Tax Act*.

Helping Small Businesses

Quarterly remittance of withholding amounts

Employers are required to withhold income taxes, employment insurance (EI) premiums and Canada Pension Plan (CPP) contributions from their employees' pay, and remit those amounts, along with the employer's portion of EI and CPP, to the government. Most employers are required to remit withholding amounts on a monthly basis, while large employers must remit more frequently. Those with average monthly withholding amounts between \$15,000 and \$50,000 remit bi-monthly, and those with withholding amounts greater than \$50,000 must remit within three days of the pay period.

Through the Joint Forum to Reduce Paper Burden on Small Business, the small business community told the federal government that very small employers view the monthly remittance of withholding amounts to be overly burdensome. These small employers often do not have the resources available to larger employers, and consequently, face a greater administrative burden from filing monthly remittances.

The Joint Forum recommended reducing the frequency of remittances for very small employers. The government accepts their recommendation as it will make compliance easier for small employers as well as reduce administration and processing costs for the government.

The budget proposes allowing small employers with average monthly withholding amounts of less than \$1000 for the second preceding calendar year and no compliance irregularities for the preceding 12 months, to remit only on a quarterly basis. Perfect compliance records for both withholdings and goods and services tax (GST) remittances will be required. Quarterly remittance periods would end on March 31, June 30, September 30 and

December 31, and the remittances would be due by the 15th of the month following the end of the quarters.

It is proposed that the quarterly remittance program commence in the fall of 1997 such that the withholding amounts for October and November, that would otherwise be required on November 15 and December 15, 1997, will be deferred to January 15, 1998. In support of this initiative, Revenue Canada will review compliance records for the 12 months preceding October 1, 1997 of all employers with average monthly withholdings of less than \$1,000 in 1995. Those employers with a perfect compliance record throughout the 12-month period will be notified of their eligibility. Participation in the program will be voluntary. A participant who makes a late payment or fails to remit will be dropped from the program and required to remit monthly. For each new calendar year, Revenue Canada will notify qualifying employers of their eligibility, and notify employers who will no longer qualify because their average monthly withholdings during the second preceding calendar year were \$1000 or greater. Businesses that satisfy the requirements may also apply to Revenue Canada for quarterly remittances at any time during the year.

The estimated revenue impact is \$180 million in 1997-98. This is largely a one-time impact due to withholding amounts from January and February 1998 being paid April 15 and credited to the 1998-99 fiscal year, rather than the 1997-98 fiscal year as would have been the case with monthly remittances. There is also an estimated \$5 million ongoing annual cost due to carrying costs arising from the delay in receiving withholding amounts.

Labour-sponsored venture capital corporations (LSVCCs)

The federal government and most provincial governments continue to provide generous tax assistance to individuals in respect of the acquisition of shares in LSVCCs to facilitate access to capital for small- and medium-sized enterprises (SMEs). The federal government provides a 15-per-cent credit for the acquisition of shares of LSVCCs, to a maximum purchase of \$3,500. By improving access to capital for SMEs, LSVCCs have helped many SMEs create and maintain jobs. Under the current LSVCC rules, LSVCCs are required to invest in businesses which have assets up to \$50 million and up to 500 employees. The budget proposes a number of improvements to rules governing LSVCCs.

While access to capital for SMEs has improved significantly in recent years, some very small businesses continue to have difficulty finding equity financing. The federal government will therefore encourage LSVCCs to invest more actively in small businesses. It is proposed that every \$1 in an eligible investment made by an LSVCC after February 18, 1997 in a business with \$10 million or less in assets (immediately before the investment is made) be counted one-and-a-half times toward the LSVCC's 60-per-cent business investment requirement.

In the province of Ontario, some LSVCCs are registered federally and provincially (dual-registrants), and must comply with federal and provincial business investment requirements. Others are registered only provincially and are not subject to federal business investment requirements. The co-existence in a province of LSVCCs subject to different business investment requirements is not a significant issue in any other province. Currently, to be an eligible business for the purposes of the federal 60-per-cent business investment requirement, the business must not have more than \$50 million in total assets, including the amount invested by the LSVCC. Under Ontario rules, a similar test is conducted immediately before the investment is made by the LSVCC. As a result, Ontario LSVCCs that are not registered federally may invest in businesses that are not eligible investments for LSVCCs registered federally. In an effort to harmonize federal and provincial rules, it is proposed that, for investments made after February 18, 1997, the federal size test be conducted immediately before the LSVCC's investment. This change is consistent with a recommendation of the House of Commons Standing Committee on Finance.

Existing rules may prevent LSVCCs from further investing in the businesses that they have helped succeed, and that need further capital injections to help them reach their full potential. Currently, an LSVCC may not invest more than 10 per cent of its shareholders' equity, to a maximum of \$10 million, in any one business. It is proposed to increase the \$10 million maximum to \$15 million effective for investments made after February 18, 1997. The 10-per-cent requirement will remain to ensure that LSVCCs continue to maintain a diversified venture investment portfolio.

Currently, an LSVCC registered under provincial law (but not federal) is not liable to pay any amount under the *Income Tax Act* (ITA) if it fails to meet the business investment requirements under provincial legislation. This means that non-compliance with business investment requirements is less onerous for such an LSVCC

than for a dual-registrant. It is thus proposed that where, as a consequence of non-compliance with business investment requirements, an amount becomes payable to a province by such an LSVCC, that the LSVCC be liable to pay an equal amount under the ITA. This measure is effective with respect to amounts that become payable to a province after February 18, 1997 by such LSVCCs. Refunds of such amounts paid under the ITA will be provided to the extent the corresponding amounts are refunded under provincial law.

At present, certain taxpayers are permitted to elect to treat any gain or loss arising on disposition of Canadian securities as a capital gain or loss. However, certain categories of taxpayers (including a trader or dealer in securities) are not entitled to this election. To remove uncertainty in this regard, the budget also proposes that there be changes to ensure that LSVCCs and other mutual funds can elect to treat gains from the dispositions of Canadian securities as capital gains.

Additional details on these proposals, together with information on changes of a technical nature, are provided in the accompanying Notice of Ways and Means Motion to amend the *Income Tax Act*.

Improving the Retirement Income System

Pension adjustment reversal (PAR)

For individuals who leave registered pension plans (RPPs) or deferred profit sharing plans (DPSPs) before retirement, the budget proposes to introduce a pension adjustment reversal (PAR) which will restore lost RRSP contribution room. The government announced its intention to examine this issue in the 1995 budget.

PAR will improve the fairness of the system of tax assistance for retirement saving by ensuring that individuals who receive low termination benefits from such plans – because of job changes early in their career, for example – have the opportunity to make up for this shortfall through additional RRSP contributions.

Lost RRSP room

When an individual is a member of an employer-sponsored RPP or DPSP, the employer is required to report a pension adjustment (PA) amount that reflects the individual's participation in the plan. The PA amount reduces the individual's RRSP deduction room dollar

for dollar. If the individual leaves the plan before retirement, the termination benefit paid by the plan could be less than the total PAs reported while the individual was a plan member – i.e. less than the RRSP deduction room given up during the years of plan membership. Generally, PAR will increase the individual's RRSP deduction limit by the amount by which the PAs exceed the termination benefit – thereby restoring the RRSP room that would otherwise be lost permanently.

PAR reporting requirements

PARs will have to be calculated whenever an individual ceases, after 1996 and before retirement (i.e. before receiving periodic payments), to have any entitlement to benefits under a DPSP or under a benefit provision of an RPP (other than a specified multi-employer plan). When PAR is greater than zero, the RPP administrator or the DPSP trustees will have to report it to Revenue Canada within a specified period of time. In order to give administrators and trustees time to adjust to the new reporting requirements, PARs for terminations in 1997 and 1998 will not have to be reported before the end of 1998. PARs for terminations after 1997 will be added to an individual's RRSP deduction room for the year of termination. PARs for terminations in 1997 will be added to RRSP deduction room for 1998.

Calculating PARs

An individual's PAR under a money purchase provision of an RPP will generally be equal to the total of all amounts included in the individual's pension credits under the provision since 1990 but not vested in the individual. PAR under a DPSP will be determined in the same manner.

An individual's PAR under a defined benefit RPP provision will generally be equal to the individual's total pension credits plus past service pension adjustments (PSPAs) under the provision since 1990, minus any lump sum payments made to the individual, or transferred to an RRSP or other money purchase-type registered plan, in respect of the individual's post-1989 benefits under the provision. Modifications to this basic rule are discussed in the section entitled "PARs and past service events".

Defined benefit pension credit offset and other changes

The 1995 budget indicated that any measure to restore lost RRSP deduction room would be revenue neutral. To accomplish this, the budget proposes to modify the way in which pension credits are calculated for individuals who accrue benefits under a defined benefit provision of an RPP. Currently, the calculation contains a \$1,000 offset which reduces an RPP member's PA and increases the RRSP deduction room available to the member. For pension credits calculated for 1997 and future years, the \$1,000 offset will be reduced to \$600.

Similarly, the \$1,000 offset that applies to the determination of amounts that reduce RRSP deduction room for individuals participating in certain unregistered pension arrangements (e.g., federal judges and Canadians who are members of foreign pension plans) will be reduced to \$600 for 1998 and future RRSP years. (It should be noted that, as set out in the 1996 budget, the RRSP deduction room for high-income earners in such arrangements will continue to be nil during those years in which the RRSP limit is less than \$15,500.)

Currently, there are special rules for determining an individual's pension credit under a DPSP or benefit provision of an RPP, if the individual terminates from the plan before becoming vested. These rules ensure that the individual's pension credit for the year of termination does not exceed the individual's contributions in that year. In effect, this precludes any loss in RRSP deduction room for the year of termination. With the introduction of PAR, these rules will become redundant and will be eliminated in determining pension credits for 1997 and future years.

PARs and past service events

This section describes the framework for proposed changes to the *Income Tax Regulations* dealing with the impact of PARs on the determination of PSPAs and vice versa. This information is for administrators of RPPs with defined benefit provisions, and is intended to assist them in making preparations for the introduction of PAR.

The information in this section relates primarily to past service events as a result of which an individual's benefits under a defined benefit provision are reinstated or are replaced with benefits under another defined benefit provision. There are special rules in subsection 8304(5) of the regulations for calculating PSPAs for such past

service events. These rules (the “modified PSPA rules”) provide an offset in the PSPA calculation for pension credits and PSPAs associated with the benefits being reinstated or replaced.

Generally speaking, with the introduction of PAR, an individual’s PSPA will be determined *without* any offset for prior pension credits and PSPAs if the individual ceased to be entitled to the prior benefits before the past service event. However, the offset will continue to apply if the individual ceased to be entitled to the prior benefits before 1997, reflecting the fact that there is no PAR to support the additional amount of PSPA that would be determined without the offset. The offset will also continue to apply if the past service event occurred *before* the individual ceased to be entitled to the prior benefits, and any PAR subsequently determined in connection with the prior benefits will be modified to take this into account. These changes are discussed in more detail below.

Effect of PAR on PSPAs

For past service events that occur before 1998, there will be no changes to the PSPA rules. This will ensure that the introduction of PAR will not disrupt the processing of past service events in 1997. (However, as noted below, such a past service event may affect the calculation of a PAR.)

For past service events that occur after 1997, the regular PSPA rules in subsection 8303(3) of the regulations will replace the modified PSPA rules where:

- the individual had previously been entitled to benefits (the “prior benefits”), either under the current provision or under another defined benefit RPP provision, in respect of the past service period; and
- the individual had ceased to have any entitlement to the prior benefits after 1996 and before the past service event.

The fact that the regular PSPA rules apply means that there is no offset in the PSPA calculation for pension credits and PSPAs associated with the prior benefits, reflecting the fact that credit has already been given for those pension credits and PSPAs in determining the individual’s PAR in connection with the prior benefits.

Furthermore, the regular PSPA rules will be amended to include in the PSPA calculation an additional amount where the termination benefit paid in connection with the prior benefits was greater

than the total pension credits and PSPAs associated with the benefits – that is, where PAR was zero – and all or part of the termination benefit was transferred to an RRSP or other money purchase-type registered plan. In general terms, the amount that will be added to the PSPA is the amount by which the transfer exceeds the total prior pension credits and PSPAs. This may result in the excess having to be withdrawn, or transferred to the defined benefit provision to fund the new benefits, in order for those benefits to be provided, thus ensuring that there is no doubling up of tax assistance.

Effect of past service events on PAR

As noted above, when the modified PSPA rules apply, the PSPA is offset by the amount of any pension credits and PSPAs associated with benefits previously provided to the individual for the period of past service. Thus, in determining PARs, it is appropriate to take into account the extent to which such offsets have reduced PSPAs.

Accordingly, the rules for determining PAR will require that the PAR that would otherwise be determined in such circumstances be reduced by the amount that would have been the PSPA for the new benefits if the PSPA had been determined using the regular PSPA rules – that is, ignoring any prior pension credits and PSPAs – and there had been no qualifying transfers from a money purchase-type registered plan to fund the new benefits. (A PSPA determined in this manner is referred to in the remainder of these notes as a “grossed-up PSPA”.) This recognizes that the prior benefits have not been lost, they have been replaced. Usually in this situation, PARs will be nil.

Where, in this situation, PSPA is being determined under one particular RPP and PAR is being determined under another, the administrator of the particular RPP will be required, within 60 days of the past service event, to advise the other RPP administrator of the existence of the event and, where the associated PSPA is exempt from certification (for example, where the PSPA is nil), of the amount of the grossed-up PSPA. Where the PSPA is not exempt from certification, the particular RPP administrator will be required to advise the other administrator of the amount of the grossed-up PSPA within 60 days of certification. However, no notification in respect of past service events occurring in 1997 will be required before the end of 1997. These notification requirements will ensure that the other RPP administrator is aware that PAR must be reduced, and that he or she is able to determine the reduced PAR amount.

To summarize, these special PAR rules will apply in the following circumstances:

- whenever an individual's benefits under a defined benefit provision are replaced with benefits under another defined benefit provision and the past service event occurs before or at the time the individual ceases to be entitled to the prior benefits; and
- when an individual's benefits under a defined benefit provision are reinstated, or are replaced with benefits under another defined benefit provision, and the past service event occurs after the individual ceases to be entitled to the prior benefits but before the end of 1997.

Reflection of past service benefits in PAR

As noted above, the basic PAR calculation under a defined benefit provision is, in general terms, the amount by which the individual's pension credits and PSPAs under the provision exceed the individual's termination benefit. Where benefits have been provided on a past service basis, the associated PSPA may not fully reflect the "PA value" of the past service benefits. This would be the case when the modified PSPA rules had applied or the individual had made qualifying transfers from a money purchase type registered plan to fund the benefits (which reduce PSPA under both the modified and the regular PSPA rules). To ensure that PAR does not underestimate the loss of benefits on termination in this situation, the PAR calculation will take into account the grossed-up PSPA amount (rather than the actual PSPA amount) associated with any past service benefits provided under the plan.

CPP/QPP lump sum payments

An individual receiving disability benefits relating to preceding years under the Canada Pension Plan (CPP) or the Quebec Pension Plan (QPP) may elect to have the amounts taxed as if they had been received in those years. It is proposed that this provision be extended to apply to all types of benefits received under those plans after 1995.

Towards a National Child Benefit System

Currently, over \$5.1 billion in assistance is provided to more than three million families under the Child Tax Benefit. Through this program, the federal government provides an annual basic benefit of \$1,020 per child, a supplement of \$75 for the third and each subsequent child, and an additional supplement of \$213 for each child under age seven when no child care expenses are claimed. The basic benefit is reduced by 5 per cent of family net income above \$25,921 (2.5 per cent for one-child families). A Working Income Supplement (WIS) of up to \$500 is also paid to low-income working families with incomes up to \$25,921. The WIS enhances support to low-income families and helps working parents offset a portion of the extra cost of working. The WIS is phased in over the family earnings range of \$3,750 to \$10,000. It is reduced by 10 per cent of family net income above \$20,921. The maximum WIS is scheduled to increase to \$750 in July 1997 and \$1,000 in July 1998.

The Government of Canada is proposing to allocate \$600 million in new funds, in addition to the \$250 million announced in the 1996 budget, to introduce a \$6.0 billion Canada Child Tax Benefit effective July 1998, or sooner if that proves possible. Discussions with provinces and territories will be followed by the introduction of federal legislation in the fall.

As an interim measure, the government proposes to restructure the WIS from a family basis to a per-child basis, consistent with the structure of the proposed federal platform and child allowances under social assistance. The modified WIS will be introduced in July 1997 and enriched by \$195 million instead of the \$125 million proposed in the 1996 budget. Of this additional \$70 million enrichment, \$50 million will be spent in the 1997-98 fiscal year and \$20 million in the 1998-99 fiscal year.

Maximum levels for the modified WIS will be \$605 for a one-child family and \$1,010 for a two-child family. For larger families, the maximum WIS will be \$1,010 plus an additional \$330 for the third and each subsequent child. The WIS will continue to be phased in at annual family earnings of \$3,750, reaching the maximum at an earnings level of \$10,000. The supplement will be reduced based on the level of family net income in excess of \$20,921. The reduction rate will be 12.1 per cent for a one-child family, 20.2 per cent for a two-child family and 26.8 per cent for families with three or more children.

Tax Measures for Canadians With Disabilities

The budget proposes several tax measures to increase assistance to persons with disabilities.

Broadening the medical expense tax credit

The existing medical expense tax credit recognizes the effect of above-average medical expenses on the ability of an individual to pay tax. It does this by providing a tax credit for eligible medical expenses in excess of a certain percentage of individual net income. For 1997, the medical expense tax credit reduces the federal tax of a claimant by 17 per cent of qualifying unreimbursed medical expenses in excess of the lesser of \$1,614 and 3 per cent of the claimant's net income. When provincial taxes are also taken into consideration, the credit provides tax relief of about 25 per cent of eligible medical expenses. In 1995, about 1,330,000 individuals claimed the credit.

The budget proposes that the list of expenses eligible for the medical expense tax credit be broadened to include:

- 50 per cent of the cost, to a maximum eligible expense of \$1,000, of an air conditioner necessary to help an individual cope with a severe chronic ailment, disease or disorder;
- 20 per cent of the cost, to a maximum eligible expense of \$5,000, of a van that is adapted, or will be adapted within six months, for the transportation of an individual using a wheel chair;
- sign language interpreter fees;
- expenses incurred for moving to accessible housing;
- reasonable expenses relating to alterations to the driveway of an individual's principal place of residence where the individual has a severe and prolonged mobility impairment and the alterations are made to facilitate the individual's access to a bus; and
- an increase in the limit for part-time attendant care from \$5,000 to \$10,000.

Eliminating the \$5,000 limit on the attendant care deduction

Current rules allow those with severe and prolonged mental or physical impairments to deduct up to two-thirds of their earned income to a maximum deduction of \$5,000 of attendant care expenses that are necessary to allow the individual to work. To reduce barriers to work for people with disabilities, the budget proposes to eliminate the \$5,000 limit on the deduction for attendant care expenses. Workers with disabilities will now be able to deduct the cost of attendant care expenses up to two-thirds of their earned income. This change will allow most disabled workers to deduct the full cost of attendant care.

Disability tax credit certification

The existing disability tax credit improves tax fairness by recognizing the effect of a severe and prolonged disability on an individual's ability to pay tax. For 1997, the credit reduces federal tax by about \$720 and combined federal-provincial tax by about \$1,120. It is available to individuals with a severe and prolonged mental or physical impairment that markedly restricts their ability to perform basic activities of daily living. In 1995, about 543,000 individuals claimed the disability tax credit.

To qualify for the disability tax credit, individuals must currently be certified by a medical doctor or, where the impairment is an impairment of sight, an optometrist. The budget proposes to allow audiologists to certify eligibility for the disability tax credit in respect of hearing impairments.

Trusts and people with disabilities

Trusts allow individuals (known as trust "settlers") to transfer property to a trust for the benefit of other individuals or "beneficiaries" of the trust. Trusts may be used for many different purposes including meeting the needs of beneficiaries with disabilities.

The undistributed income earned by a trust is normally taxed at the trust level. An exception to this general rule is currently made in the case of beneficiaries qualifying for the disability tax credit. The existing preferred beneficiary election allows the income earned by a trust to be taxed as if it had been paid out to a preferred beneficiary. A preferred beneficiary is a beneficiary under a trust who is

entitled to the disability tax credit and is in a close family relationship with the settlor of the trust. Although the funds stay in the trust, the election allows the income of the trust to be taxed in the hands of a preferred beneficiary, who may be subject to tax at a lower tax rate than the trust.

The budget proposes to broaden the definition of a preferred beneficiary to include adults who are dependent on others by reason of mental or physical infirmity. This measure will apply to individuals for whom an infirm dependant credit can be claimed.

Changes to the *Customs Tariff*

It is proposed that the *Customs Tariff* be amended to provide duty-free entry for all goods specifically designed for the use of persons with disabilities. This measure is effective February 18, 1997.

Refundable medical expense supplement for earners

The loss of subsidies for disability-related supports under provincial social assistance can be an important barrier to participation in the labour force by Canadians with disabilities. To address this problem, the budget proposes to introduce a refundable tax credit for low-income working Canadians with higher than average medical expenses.

The refundable tax credit will be based on eligible medical expenses and reduced by a percentage of family net income above a threshold. The credit will be available to workers with at least \$2,500 in earned income. It will be the lesser of \$500 and 25 per cent of the allowable portion of expenses that can be claimed under the medical expense tax credit. To target assistance to those with low incomes, the credit will be reduced by 5 per cent of family net income in excess of \$16,069. Individuals claiming this credit may also claim the medical expense tax credit.

These changes, except where noted, will be effective for the 1997 and subsequent taxation years.

Measures to Enhance Tax Assistance to Charitable Giving

Recent budget changes to enhance tax assistance

To support the important work of charities in meeting the needs of Canadians, generous incentives are provided in the tax system. For individual donors, a federal tax credit at the rate of 17 per cent is provided on the first \$200 of donations each year, while a federal tax credit of 29 per cent is available for the portion of donations exceeding \$200 up to the applicable net income limit. When combined with the impact on provincial taxes, this results in total tax assistance of roughly up to 52 per cent of the value of the gift – i.e. there is a 50/50 partnership between the donor and governments. Corporate donors are allowed to deduct charitable gifts up to the applicable net income limit in calculating their taxable income, producing federal and provincial tax assistance of up to 43 per cent. Individual donors claimed tax credits in respect of \$3.4 billion of donations, while corporate donors deducted \$526 million of donations in 1994.

Tax incentives for charitable giving have been enriched in each of the 1994, 1995 and 1996 budgets.

In the 1994 budget, the threshold for the higher 29-per-cent credit was lowered from \$250 to \$200. In the 1995 budget, donations of ecologically sensitive land were exempted from the net income limits. In the 1996 budget, the amount of donations eligible for the credit was increased: the general annual limit was raised from 20 to 50 per cent of net income; the limit on donations in the year of death and donations carried back to the preceding year was raised from 20 to 100 per cent of net income; and to eliminate the potential cash flow impacts arising from the donation of appreciated capital property, the general limit of 50 per cent was further increased by half the amount of taxable capital gains resulting from the donation of capital property. It was also announced that ways of further encouraging charitable giving would be examined during the year.

Building on existing incentives and recent enhancements to tax assistance

Following extensive consultations with the charitable sector, the government proposes in this budget additional changes to build on existing incentives and recent enhancements.

Donations to the Crown and Crown foundations may be claimed for tax purposes up to 100 per cent of the taxpayer's net income for the year. Donations to other charities, on the other hand, may be generally claimed only up to 50 per cent of net income. Representations to the government have indicated that the different net income limits may distort the pattern of giving in Canada, especially for large gifts. A standard limit of 75 per cent of net income is thus proposed for all charitable donations and Crown gifts claimed by individuals or corporations for taxation years commencing after 1996. This limit will level the playing field across charities, and encourage more donations by providing enhanced ability to claim tax assistance in the year of donation for the most generous donors. It is proposed that this limit be further increased by 25 per cent of any taxable capital gain arising from the donation of appreciated capital property to continue to ensure that any tax liability arising from the donation of such property can be offset by tax credits in the year of donation. Donations in the year of death and the preceding year, as well as donations of ecologically sensitive land and Canadian cultural property will still be eligible up to 100 per cent of net income.

The budget proposes to reduce the income inclusion rate on capital gains arising from certain donations by individuals or corporations to charities (other than private charitable foundations) from 75 per cent to $37\frac{1}{2}$ per cent. Donations that will be eligible will be those of securities, such as shares, bonds, bills warrants and futures, that are listed on a prescribed stock exchange, where the donation is made between February 18, 1997 and the end of the calendar year 2001. Prescribed stock exchanges are listed in the *Income Tax Regulations* and include five Canadian stock exchanges (Alberta, Montreal, Toronto, Vancouver and Winnipeg) and a number of foreign stock exchanges. This measure will provide a level of tax assistance for donations of eligible appreciated capital property that is comparable to that in the U.S. (see box on next page). While the existing treatment of charitable donations is already generous, this change will facilitate the transfer of appreciated capital property to charities to help them respond to the needs of Canadians.

Combined federal and provincial tax assistance for cash donations in Canada reaches up to 52 per cent (the 29-per-cent federal credit also reduces surtaxes and provincial taxes to a total of 52 per cent of the value of the donation), whereas combined federal and state tax assistance is up to 43 per cent for high-income earners in a typical American state.

The U.S. tax code exempts donations of appreciated capital property from capital gains tax. The tax assistance accruing to donations of such property depends on both the rates of tax credits or deductions, the rate at which any capital gains are included in income, and the length of time that the asset has been held. Experience from the United States indicates that a typical capital gain realized on the donation of appreciated capital property can represent about 60 per cent of the value. The full capital gains exemption thus increases the tax assistance on such donations by up to 19 per cent, resulting in maximum tax assistance up to 62 per cent on donations of such property in a typical U.S. state.

For a typical donation of eligible appreciated capital property in Canada, the proposed reduction to the income inclusion rate from 75 per cent to 37½ per cent will increase the rate of tax assistance by about 12 per cent. Combined with the 52-per-cent assistance already provided by the charitable donations tax credit, this will result in tax assistance of up to 64 per cent for donations of eligible property in a typical province.

To reinforce the 1995 budget measure to encourage donations of ecologically sensitive lands, it is proposed that a provision be introduced to change the method of valuing donations of easements, covenants and servitudes in respect of such land. Easements, covenants and servitudes protect ecologically sensitive lands by preventing development now and in the future. Normally, the value of a donation is determined to be what a purchaser would pay for the property on the open market. As there is no established market for such restrictions, the fair market value determined under this method is often minimal. It is proposed that the value of the donation now be deemed to be the greater of the fair market value of the restriction otherwise determined, and the amount by which the fair market value of the land to which the gift relates is decreased as a result of the gift. This would reflect the amount of the donation more accurately. This measure would be effective for donations made after February 27, 1995.

It is proposed that donations of depreciable assets such as buildings and equipment be encouraged by adjusting the amount of donations the donor can claim as a percentage of net income. In the 1996 budget, net income limits of taxpayers donating appreciated capital property were increased to reflect the inclusion in income of taxable capital gains arising from the donation. Donors of depreciable capital property that has a value greater than its depreciated value for tax purposes may find themselves with a tax liability. This flows from the recapture of capital cost allowance (CCA) that arises when the asset depreciates more slowly than is claimed for tax purposes. This budget proposes to increase the net income limit by 25 per cent of any CCA recapture arising from donations of depreciable capital property by individuals or corporations for taxation years commencing after 1996. This would ensure that donors of these assets will always have enough tax credits or deductions to more than offset the tax arising from the recapture of CCA. This measure would be of particular benefit to taxpayers donating buildings, equipment and other similar assets. It will also aid in the preservation of heritage buildings across Canada.

Strengthening Canadians' confidence in, and understanding of, the charitable sector

Charitable giving depends on donors having confidence that their donations will be used in an effective and efficient way. On the whole, the charitable sector works well and is very careful with the donors' funds. Any perception of waste or abuse, however, undermines donors' confidence and has the potential to reduce charitable giving.

A number of changes are proposed in this budget to increase donors' confidence that their donations are being put to good use and to ensure that tax assistance is properly targeted to meet the needs of Canadians. These measures will improve donors' access to information about charities, and provide for greater transparency with regard to charities' affairs. Greater transparency will increase self-discipline in the charitable sector, and empower donors to play a better role in monitoring the sector. As well, these changes will enable Revenue Canada to better address concerns that have been raised regarding those few charities that are not meeting the requirements for charitable status.

In addition to the annual information return filed by charities, the public will have access to other documents filed by charities, including:

- governing documents, including statement of purpose;
- any information required to be provided by a charity upon applying for registration if registration has been granted;
- notification of registration, including any conditions or warnings;
- where the registration of the charity has been revoked, any letter sent by, or on behalf of, the Minister of National Revenue to the charity indicating the grounds for the revocation; and
- lists of directors of newly registered charities (for existing charities, they appear in the information returns that are already public).

In addition to making more information available to the public, Revenue Canada will examine ways to make this information more widely available. Revenue Canada will also expedite the process of deregistering charities that fail to provide the necessary information. As well, Revenue Canada will be provided with additional resources to ensure that all charities comply with the *Income Tax Act* and that charitable status is conferred only on those organizations that should have it.

For enhanced incentives to generate additional donations, it is important that donors and potential donors understand the value of the tax assistance that is available. The incentives for charitable donations are among the most generous in the tax system. Many donors, however, appear to underestimate the tax assistance currently available. Revenue Canada will provide more information to charities on how to explain the value of the tax assistance to donors.

Finally, measures will be introduced to prevent potential abuses involving transactions by taxpayers not dealing at arm's length with charities and loan-back transactions. Loan-backs are transactions through which some taxpayers have been attempting to earn tax credits without having to forgo the use of funds by transferring funds to a charity, and receiving a loan of the funds back from the charity, sometimes immediately. Revenue Canada is of the view that these transfers are not gifts as they are not made unconditionally.

To prevent potential abuse involving these types of transactions, it is proposed that a special tax be imposed on the charity of 50 per cent of the amount of a debt, or of the fair market value of shares acquired by the charity from a person with whom the charity does not deal at arm's length. Similarly, it is proposed that the same special tax be imposed where, within five years after a donation to a charity, the charity holds a debt or a share issued by the donor (or a person with whom the donor does not deal at arm's length),

or allows property of the charity to be used by the donor (or a non-arm's length person). Shares and debt listed on prescribed stock exchanges as well as amounts held on deposit at a financial institution will be exempt from these rules. In addition, it should be noted that Revenue Canada will continue to challenge loan-back arrangements effected before February 18, 1997.

Business Tax Measures

Review of transfer pricing provisions

The growth of international trade in recent years has meant a corresponding increase in the volume of goods, services and intangible property traded among related parties (i.e. parties that do not deal at arm's length) that are situated in different countries. As a result of this growth, tax administrations around the world have recently focused more attention on the issue of international transfer pricing. A number of important changes affecting the way governments apply and enforce international transfer pricing rules (i.e. the domestic income tax rules governing the determination of the income and expenses relating to such cross-border intra-group trade) have resulted. In view of these and other developments, Canada will be updating its current practices in the area of transfer pricing and will be introducing new documentation requirements to ensure taxpayer compliance and facilitate administration by Revenue Canada.

Canadian transfer pricing law and administrative practices are based on principles developed by the Organization for Economic Co-operation and Development (OECD). After a thorough review of existing guidelines published in 1979, the OECD issued revised guidelines in 1995 which updated the existing international standard in this area. The fundamental reference point for this standard is the "arm's length principle", the yardstick used to ensure that prices charged between related parties on cross-border transactions correspond to those that would have been charged between unrelated parties. This standard protects the tax base against the shifting of income that can potentially occur from the discretionary determination of transfer prices on transactions made between related parties situated in different countries. The international adherence by all industrialized countries to a common standard also prevents the double taxation of profits of multinational enterprises by two or more tax jurisdictions and, consequently, promotes international trade.

OECD guidelines on transfer pricing

The OECD guidelines on transfer pricing represent the consensus position of all member countries and set out internationally acceptable approaches for dealing with transfer pricing issues among nations. The guidelines offer practical guidance for both taxpayers and tax administrations with regard to methods that can be used to determine whether prices on transactions undertaken by related parties situated in different countries are in accordance with the “arm’s length principle”. This principle rests on a comparison of the conditions of transactions between related parties with conditions observed between independent parties in similar circumstances entering into similar transactions. This is why the guidelines express a clear preference in favour of so-called “transaction-based” methods to determine arm’s length prices, since they focus on the conditions of comparable transactions undertaken by independent parties. These transaction-based methods are:

- the “comparable uncontrolled price” method, which requires a comparison with prices on transactions for similar goods or services with (or between) independent parties;
- the “cost plus” method, which requires a comparison with profit mark-ups applied by independent parties on the cost of production of similar goods or services, in order to obtain the arm’s length sale price that should be charged by the taxpayer for the goods or services; and
- the “resale price” method, which requires a comparison with profit mark-ups applied by independent parties on the sale of similar goods, in order to obtain the arm’s length purchasing price that should be paid by the taxpayer to a related party in respect of the goods subsequently being resold to third parties.

The guidelines also authorize, in limited circumstances, the use of profit-based methods when the transaction-based methods cannot be used with a sufficient degree of reliability. These methods are:

- the “transactional profit split” method, which determines the division of profits that independent parties would have expected to realize, based upon functions performed, assets used and risks assumed, from engaging in transactions similar to those entered into between the related parties; and
- the “transactional net margin” method, which examines the net profit margin realized by a taxpayer from one or more transactions (to the extent that they can be properly aggregated) with related parties and compares it to the net profit margin realized by independent parties in similar circumstances.

Profit-based methods tend to be less precise than transaction-based methods because they focus on net profits (more precisely, net profits earned in respect of aggregate intra-group transactions) as opposed to the terms of the transactions. For this reason, the OECD guidelines consider them methods of last resort, whose use will be carefully monitored by member countries.

The revised OECD guidelines also address a number of administrative issues relating to transfer pricing. New guidance is provided regarding the nature and extent of the documentation of related-party transactions that can reasonably be expected by tax administrations from taxpayers, as well as the imposition of penalties relating to transfer pricing. The issue of documentation is not insignificant, since the determination (and subsequent verification) of transfer prices is a fact-sensitive matter. Unfortunately, taxpayers sometimes neglect to document properly their transactions with related parties or the basis upon which transfer prices are determined. This can make transfer pricing audits lengthy and inefficient for both taxpayers and Revenue Canada.

In view of the above, the government will shortly propose changes to the *Income Tax Act* that will pursue the following objectives:

- to harmonize the standard contained in section 69 of the Act with the arm's length principle as defined in the revised OECD guidelines and ensure that, in selecting the most appropriate pricing method, all the various methods described in the OECD guidelines are available to taxpayers; and
- to ensure the contemporaneous documentation by taxpayers of cross-border related-party transactions, so that taxpayers are in a position to provide to Revenue Canada, on a timely basis, the relevant information supporting the transfer prices used in the course of their related-party transactions. This will improve the ability of Revenue Canada to administer the law and make audits more efficient from a taxpayer perspective. Penalties commensurate with a transfer pricing adjustment would apply where these documentation requirements are not met or where the taxpayer did not act diligently in establishing transfer prices that are in conformity with the arm's length principle.

The government recognizes that documentation requirements should not impose an undue burden on taxpayers and that a balance must be struck between the benefits for taxpayers and Revenue Canada of having relevant and timely transfer pricing information available and the cost for taxpayers of complying with these documentation requirements.

These changes will be effective for taxation years that begin after 1997. In view of the resource intensive nature of transfer pricing examinations, additional efforts will also be directed at the

administration and enforcement of the new rules. Revenue Canada will, in coming years, increase resources devoted to transfer pricing audits in the field.

The proposed statutory provisions will require a revision of Revenue Canada's administrative position that is currently set out in *Information Circular 87-2*. Further details on the proposed legislative changes, together with the revision of Revenue Canada's administrative position, will be released in draft form in the coming months and will be the subject of consultations with interested parties.

Restriction on claiming investment tax credits

In the 1994 budget, the government responded to concerns about the increasing number of taxpayers who were reopening the calculation of tax credits for scientific research and experimental development (SR&ED) in respect of expenditures made in earlier years. These concerns were addressed by restricting the SR&ED tax credits to those SR&ED qualifying expenditures identified by the taxpayer within a specified period. This deadline is 12 months after the taxpayer's filing due date for the taxation year in which the SR&ED expenditure was incurred.

The potential exists for taxpayers to reopen the tax credit calculation with regard to other investment tax credits (ITCs). This is inconsistent with the goal of these tax credits which is to encourage investment which might not otherwise occur. Where investment has taken place without any expectation of entitlement to an ITC, the provision of an ITC in respect of that investment at a much later time is in the nature of a windfall for the taxpayer.

The budget proposes, therefore, to restrict the eligibility for all ITCs claimed after February 18, 1997 in a manner similar to the restriction in place for SR&ED qualifying expenditures. Specifically, eligibility for an ITC will be limited to those qualifying expenditures identified by a taxpayer on a prescribed form (i.e. *Investment Tax Credit – Form T2038*) filed with the Minister of National Revenue within 12 months of the taxpayer's filing due date for the taxation year in which the property was acquired.

As a transitional measure, taxpayers will have the length of time specified above or until May 31, 1997, whichever is later, to identify the eligible expenditures.

Extension of the temporary capital tax surcharge on large deposit-taking institutions

The temporary capital tax surcharge on large deposit-taking institutions, which was originally introduced in the 1995 budget, extended in the 1996 budget and is scheduled to expire on October 31, 1997, is proposed to be extended until October 31, 1998.

This temporary surcharge applies to financial institutions as defined under Part VI of the *Income Tax Act*. However, it does not apply to life insurance companies as it is proposed that the special tax applying to life insurers under Part VI continue to apply until the end of 1998. The surcharge will continue to apply at a rate of 12 per cent of the capital tax imposed under Part VI calculated before any credit for income taxes and with a capital deduction of \$400 million. The surcharge is also not eligible to be offset by tax payable under Part I of the Act.

For taxation years that include October 31, 1998, the surcharge will be prorated on the basis of the number of days in the taxation year that are before November 1, 1998.

Environmental Initiatives

Steady progress has been made through previous budgets to advance environmental objectives through conservation and protection measures dealing with mining reclamation trusts, donations of ecologically sensitive lands, energy efficiency and renewable energy. This budget announces further steps which build on this progress and the government's ongoing commitment to sustainable development.

Environmental trusts

Certain environmentally sensitive activities can disturb the natural environment in the area where the activity takes place, and measures may need to be taken to repair the environmental damage after operations have terminated. For example, a mine site may need to be restored after mining activities have ceased. In these situations, governments may require companies to set aside funds in advance in environmental trust funds. The purpose of such an environmental trust is to ensure that adequate funds are available to conduct restoration activities at the end of operations. In other situations,

governments may be satisfied with the posting of bonds or other financial assurances that monies will be available to perform any necessary post-closure reclamation.

The 1994 budget proposed changes to the *Income Tax Act* (the rules for mining reclamation trusts) that permitted the deductibility of contributions to provincially or federally mandated trust funds that are set up for the sole purpose of restoring a mine site and that are held by an independent third-party trustee. The changes were of particular benefit to single-mine companies, because the deduction in respect of reclamation activities would otherwise have only become available when the work was incurred. This would ordinarily occur after the mine had closed and the mining company might not have sufficient income against which it could claim the deductions.

The 1996 budget proposed that the government would consult with industry, provinces and environmental groups to determine if the mining reclamation trust rules should be extended to other environmentally sensitive sectors such as waste disposal and reforestation. The consultations included a special workshop hosted by the National Round Table on the Environment and the Economy.

Financial assurances and environmental trusts

Several provinces and territories have statutory or regulatory mechanisms in place under which operators of waste disposal sites or quarries for the extraction of industrial minerals, sand and gravel (or other aggregates) may be required to post financial security (called financial assurances) in respect of the costs of restoring the site after the waste disposal activities have terminated.

Financial assurances can take many forms, including surety bonds, letters of credit, cash or environmental trust funds. Of these, environmental trusts are among the most stringent forms of financial assurance. Under an environmental trust fund, the operator is required to contribute amounts to a fund over the period in which the site is operating, and the funds must be held solely for the purpose of reclaiming the site after termination of activities.

Typically, statutory or regulatory requirements for financial assurances provide a wide degree of latitude to environmental authorities in terms of the form the financial assurance may take. In general, if the extent of environmental damage is expected to be small and the operator is financially sound, environmental authorities may be satisfied with less stringent financial assurances.

As a result of the consultations, this budget proposes that the mining reclamation trust rules be extended to similar trust funds established for waste disposal sites and quarries for the extraction of aggregates and other similar substances. Of the sectors considered, the environmental obligations, and in particular the timing of those obligations, related to waste disposal sites and quarries are the most similar to those in the mining industry. In particular, operations at a waste disposal site or quarry may last for many years, and significant restoration activities may need to be undertaken after the termination of operations, at which point the operator may not be generating income. For these reasons, waste disposal and aggregate extraction operations can be expected to derive the most benefit from extending the rules. In addition, officials in provincial environment ministries indicated that extending deductibility of contributions to trusts set up for the purpose of restoring waste disposal sites and quarries would be a useful complement to provincial initiatives in the area of financial assurances for environmental protection and restoration.

The rules applying to environmental trusts for waste disposal and aggregate extraction sites are proposed to be the same as the current rules for mining reclamation trusts. In particular:

- contributions to qualifying environmental trusts will be deductible;
- earnings of the fund will be taxed at the trust level. Operators will be required to report income earned in the trust as if it had been earned in the company, and will receive a refundable credit for tax already paid by the trust. This has the overall effect of taxing trust income as if it had been earned in the company; and
- withdrawals from the fund will be taxable. However, in general, reclamation expenses are considered to be deductible by Revenue Canada in computing taxable income. Therefore, to the extent that the funds are used to pay eligible reclamation expenses, there will be no net increase in tax arising from withdrawals from the fund.

The overall effect of these rules is to advance the timing of the deduction in respect of reclamation expenses.

As in the case of mining reclamation trust funds, the impact of these rules is consistent with the principle of “polluter pay” and with a recent recommendation from the National Round Table on Environment and the Economy that income earned in environmental trusts should be taxable. It also assists companies subject to

environmental regulations to meet their obligations under the relevant federal or provincial statutes. It achieves this result without distorting these governments' choices of instrument used to provide the assurance.

It is proposed that the changes will take effect with respect to qualifying environmental trusts after February 18, 1997.

Conserving Canadian resources and sustainable development

Incentives to invest in renewable energy and energy conservation

The 1996 budget proposed changes to improve the incentives for investments in renewable energy and energy conservation projects. The changes achieved this result by ensuring a more level playing field in the income tax treatment of renewable and non-renewable energy. The changes included the introduction of a new category of fully deductible expenses called Canadian renewable and conservation expenses (CRCEs). The 1996 budget also tightened the eligibility rules for expenses related to non-renewable energy which could be used with flow-through share financing arrangements.

Investments in energy conservation and efficiency equipment are also encouraged by allowing taxpayers to deduct the cost of such equipment at a rate of 30 per cent per year (declining balance) under Class 43.1. This rate often represents an acceleration of the depreciation which would normally be calculated for accounting purposes on these assets.

Canadian renewable and conservation expenses (CRCEs)

Regulations detailing the expenses that are eligible for inclusion in the CRCE category were released on December 5, 1996. This budget proposes one additional modification to the definition of a CRCE.

Canadian renewable and conservation expense (CRCE) category

Canadian renewable and conservation expenses include certain intangible development costs associated with projects primarily using equipment eligible for Class 43.1.

The CRCE category is similar in concept to the definition of expenses used in the non-renewable energy sector. These expenses generally include all intangible expenses incurred to determine the existence, location, extent or quality of certain non-renewable resources such as crude oil and natural gas.

CRCE was introduced to encourage investment in the pre-production development phases of energy conservation and renewable energy projects. CRCE deductions can be accumulated from December 5, 1996, when the legislation implementing the 1996 budget changes was tabled in Parliament.

Expenditures eligible for CRCE treatment are fully deductible and can be carried forward indefinitely. These expenditures can also be renounced to shareholders who have entered into a flow-through share agreement. The CRCE definition also provides taxpayers investing in renewable energy and energy conservation projects with more rapid deductions for certain other types of expenses which would normally be treated as capital in nature.

Test wind turbines

Following upon recent consultations with industry associations, this budget proposes to modify the CRCE definition released on December 5, 1996 to include the costs of acquiring and installing test wind turbines. Favourable prior opinions must be issued by the Minister of Natural Resources for each test wind turbine installation.

Eligible energy conservation equipment

This budget proposes changes to expand eligibility for Class 43.1 capital cost allowance treatment to certain acquisitions of used equipment. A reduced qualification threshold for photovoltaic systems is also proposed.

Eligibility for class 43.1 CCA treatment

Eligibility for Class 43.1 is described in draft regulations to the *Income Tax Act*. Detailed information on both Class 43.1 and CRCE eligibility criteria will be available in a revised “Technical Guide” to be released shortly by Natural Resources Canada (NRCan). Class 43.1 was introduced following the termination of Class 34. In general, the following types of equipment may qualify for inclusion in Class 43.1:

- cogeneration and specified waste-fuelled electrical generation systems;¹
- active solar systems;¹
- small-scale hydroelectric installations;
- heat recovery systems;¹
- wind energy conversion systems;
- photovoltaic electrical generation systems;
- geothermal electrical generation systems; and
- specified waste-fuelled heat production equipment.¹

¹ Active solar heating, heat recovery and heat production systems must be used directly in connection with an industrial process to qualify as Class 43.1 equipment.

Used equipment

The news release entitled “New Tax Measures for Renewables and Energy Conservation” dated June 27, 1996 proposed that only new equipment would be eligible for Class 43.1. This change was proposed to ensure that the incentive provided by the tax system is targeted towards current energy efficient technology. The budget proposes to relax these restrictions to accommodate certain used equipment to the extent that the equipment was included in Class 34 or 43.1 of the vendor, remains at the same site in Canada and is not more than five years old (from the time it was originally placed in service). The cost which can be included under Class 43.1 by the purchaser of any used Class 34 or 43.1 equipment cannot exceed the original capital cost of the equipment when first placed in service.

This change is relieving in nature and will be effective for equipment acquired after June 26, 1996.

Photovoltaic peak capacity requirement

The budget proposes to lower the minimum peak capacity requirement for photovoltaic systems from the current level of 10 to 3 kilowatts. This will permit smaller applications of solar power to qualify.

This change is also relieving in nature and will be effective for all equipment acquired after February 18, 1997.

Energy efficiency investments

The 1996 budget noted the importance of energy efficiency investments in achieving the government's environmental and economic objectives. To this end, it was subsequently announced that the Departments of Finance and Natural Resources would consult on the treatment of energy efficiency investments and investments providing heating and cooling from renewable energy sources to identify impediments. The 1996 budget also noted the importance of the development of recognized standards for energy-using equipment and structures.

Numerous submissions were received and a draft report on the consultations has been circulated to interested parties. The government found these consultations to be helpful and a broad range of ideas was presented.

One of the impediments identified was a lack of information and awareness about the benefits of technologies and practices to improve energy efficiency. Since the 1996 budget, there has been considerable progress in the development of recognized standards for buildings and houses and in the promotion of energy efficiency improvements to existing houses. The Minister of Natural Resources announced additional measures in December 1996 to address this and other impediments.

New national standards for buildings and houses

The National Research Council, under an NRCan Program co-funded by provincial energy ministries, is about to publish the *National Energy Code for Buildings* (NECB). The *National Energy Code for Houses* (NECH) is scheduled to be released soon.

National Energy Code for Buildings (NECB) and Houses (NECH)

The NECB and NECH are Canada's first comprehensive energy efficiency codes. These codes have been developed over a six-year period through a consultative process involving Natural Resources Canada, the National Research Council, provincial and territorial government energy ministries and electric utilities. Compliance with code requirements can be demonstrated by either a prescriptive or performance approach. Using the prescriptive approach, the specific thermal requirements contained in the code for each building component must be met. Using the performance approach, deviation from the prescribed value is permitted as long as the overall building energy use is equal to or less than if all components were built to the prescribed values. The codes accommodate regional variations through the use of cost and climate factors for 34 administrative regions. The NECB and NECH are primarily targeted to new construction, including buildings and additions.

The NECB has recently passed through the consensus process of the Canadian Commission on Building and Fire Codes. This code specifies minimum levels of thermal performance for commercial buildings through the establishment of minimum standards of construction for building components and features that affect a building's energy efficiency. Various authorities having jurisdiction for buildings are actively considering the NECB for adoption. Some provincial governments, and the federal government, are considering using the codes as internal guidelines for their own construction.

The NECH is due to be published soon. The code sets minimum energy efficiency standards for new houses, based on regional differences such as climate and energy costs; it is very similar to the NECB in overall structure and general level of requirements.

Home energy rating systems

There are over seven million single- and multi-family houses in Canada today. Residential energy use accounts for over 20 per cent of secondary energy use in Canada today. There is significant potential for improving energy efficiency in this sector. In particular, it is recognized that energy performance can often be improved when renovations, such as replacing windows, finishing basements and attics or replacing furnaces, are planned.

Since 1993, Natural Resources Canada has been developing the Home Energy Retrofit Initiative in response to a desire to promote energy efficient renovations. One of the elements of this program is the Canadian Home Energy Efficiency Rating System (CHEERS) which is due to be released later this year and tested through pilot projects.

Canadian Home Energy Efficiency Rating System (CHEERS)

The Canadian Home Energy Efficiency Rating System will soon be released. CHEERS will offer builders, renovators, home buyers and vendors a reliable tool to assess the energy performance of a house. The system will support a computerized analysis of a house and produce a comparative rating based on the purchased energy needed to operate the house. For existing homes, the system will also recommend specific energy efficiency improvements. NRCan is also developing audit software that will help homeowners identify cost-effective opportunities for energy efficiency retrofits.

Energy efficiency regulations

Under the authority of the *Energy Efficiency Act*, the Government of Canada has regulated minimum energy performance standards for some 20 household products, lamps and motors that are imported into Canada or traded interprovincially. The regulations are designed to phase out less efficient equipment from the Canadian market; they complement energy efficiency regulations which are currently in effect in a number of provinces.

The range of products regulated under these regulations will soon be expanded to include an additional 13 energy-using products. Performance levels will be established for such products as compact clothes dryers, dehumidifiers, gas- and oil-fired boilers and oil-fired furnaces. In addition, the existing standard for split-system central heat pumps will be strengthened. Following these initiatives, regulations will apply to energy-using products that account for more than 75 per cent of residential energy demand.

Energy efficiency and renewable energy in commercial buildings

During the consultations on energy efficiency and heating and cooling from renewable sources, a number of proposals suggested that the tax system be used to provide an incentive for energy efficient buildings. Proposals were varied in nature with some focusing on new commercial buildings (e.g., office buildings, shopping centres, hotels, motels and large apartment complexes) meeting very high energy efficiency standards. Other submissions concentrated on the need to encourage energy efficient retrofits of the existing building

stock because of the large potential gains. Still other suggestions were received to promote the use of renewable energy to meet the energy needs of buildings.

Some participants in the consultations suggested introducing new income tax incentives tied to either the C-2000 criteria or the new National Energy Code for Buildings. There was a recognition that new commercial buildings would need to exceed the NECB by a certain amount in order to demonstrate a high level of energy efficiency. In general, the higher the threshold of energy efficiency in excess of the code proposed, the more generous was the tax treatment advocated.

There was also considerable interest in encouraging greater use of renewable energy for the heating and cooling of commercial buildings. This is in recognition of the benefits that renewable energy can have in reducing emissions of certain greenhouse gases. The government acknowledges that the increased use of renewable energy for heating and cooling of commercial buildings should be encouraged.

The government is prepared to examine the appropriateness of using some tax or other mechanism to promote renewable energy, and energy efficiency investments in commercial buildings linked to the National Energy Code for Buildings. While the precise nature of the new incentive mechanism has not yet been determined, possibilities under review include, *inter alia*, an additional CCA allowance, an investment tax credit (possibly refundable) or a direct program spending initiative administered by NRCan. The government will be examining these and other alternative mechanisms. Funding totalling \$60 million to support this new initiative has been set aside – i.e. \$20 million per year for three years beginning in 1998. The new initiatives will complement other activities already underway at NRCan and be an important element in promoting investments in energy efficiency and renewable energy for new and existing commercial buildings.

Further details on this proposed new incentive mechanism will be developed in consultation with stakeholders and the final design will be announced by the Minister of Natural Resources later this year.

Sales and Excise Tax Measures

Visitors' Rebate Program

A common feature of value-added taxes around the world is the provision of rebates to foreign tourists of sales tax paid on selected purchases, such as goods and short-term accommodation.

The Visitors' Rebate Program was established to minimize the impact of the GST on the tourism industry, thereby encouraging the continued interest in Canada as an attractive vacation destination as well as a place to convene trade shows and conventions. The program will apply equally to the harmonized sales tax (HST).

The Visitors' Rebate Program also promotes exports by ensuring that the GST is removed from goods exported from Canada. Currently, non-resident visitors to Canada are entitled to claim a rebate of the GST paid on eligible goods purchased by them while in Canada, provided the goods are removed from Canada within 60 days. Rebates may also be claimed for the tax paid on short-term accommodation.

Foreign conventions (i.e. where at least 75 per cent of participants are non-residents and the head office of the convention sponsor is situated outside Canada) are permitted to claim rebates on eligible purchases, such as meeting rooms, short-term accommodation and certain other purchases of goods and services used in the course of the convention.

Since the inception of the program, there have been a number of proposals by the tourism industry to broaden the administration of the program, such as providing rebates at international airports as well as point-of-sale rebates for short-term accommodation and the expansion of the eligibility of certain goods and services which could be rebatable.

Therefore, the government is proposing a review of the Visitors' Rebate Program in order to evaluate its efficiency and effectiveness in encouraging tourism in Canada and thereby promoting the growth of employment in the tourism sector. The objective of the review is to determine whether the current design and administration of the program can be improved to more effectively target resources to promote Canada as a tourist destination and support the tourism industry in the creation of employment.

In addition, the review will study whether there are additional measures which Revenue Canada could adopt to ensure that the program is administered in the most cost-effective and efficient manner possible to achieve its goals.

The review will be conducted in consultation with the tourism industry over the next six months. The findings of the review are to be submitted to the Minister of Finance in the fall of 1997.

Amendment to the *Excise Tax Act* Concerning Measurement of Fuel Volumes

Excise taxes are imposed on gasoline, diesel fuel and aviation fuel at specific rates per litre. In recognition of the fact that fuel volumes vary according to temperature, it is proposed to amend the *Excise Tax Act* to clarify the method to be used to measure fuel for excise tax purposes.

For most commercial transactions, fuel is measured in litres corrected to the reference temperature of 15 degrees Celsius. While this temperature compensated method has become the international industry standard, the measurement of fuel in uncompensated litres nevertheless continues to be used in the domestic industry.

For purposes of accounting for excise tax, industry will continue to be able to use the temperature compensated method or the uncompensated method. It is proposed, however, that the Act be amended, effective February 19, 1997, to require excise licensees to account for excise tax using the same fuel measurement method (whether temperature compensated or uncompensated method), that they use to determine the quantity of fuel delivered and charged to a purchaser, or the quantity of fuel imported.

Tax rebate on aviation fuel

In November 1996 a program to rebate excise tax paid on aviation fuel was proposed. The government intends to proceed with this rebate program and to introduce legislation that would amend the *Excise Tax Act* and *Income Tax Act* to this effect.

Under this program, all airline companies carrying on business in Canada will be able to obtain a rebate of federal excise tax paid on their aviation fuel. However, in order to receive this rebate,

companies will be required to give up the right to use some of their accumulated tax losses that would otherwise be available to reduce federal and provincial income taxes on future profits.

Tobacco Tax Changes

The government will also be introducing legislation amending the *Excise Tax Act*, the *Income Tax Act* and the *Customs Tariff* to implement the tobacco-related changes that were proposed on November 28, 1996 and December 11, 1996.

These proposals include increased excise tax rates for tobacco products for sale in Ontario, Quebec, New Brunswick, Nova Scotia and Prince Edward Island, and a three-year extension of the corporate surtax on the profits of tobacco manufacturers.

In addition, proposed changes to the excise tax on exported tobacco products will allow foreign duty-free shops to acquire Canadian tobacco products without application of the tax. At the same time, the duty- and tax-free allowances in respect of importations of fine cut tobacco and tobacco sticks by returning residents will be reduced.

Notice of Ways and Means Motion to Amend the *Income Tax Act*

That it is expedient to amend the *Income Tax Act* to provide among other things:

Child Tax Benefit – Working Income Supplement

(1) That the provisions of the Act relating to the annual working income supplement under the Child Tax Benefit be modified with respect to amounts of the supplement that become payable during months after June 1997, in accordance with proposals described in the Budget Papers tabled by the Minister of Finance in the House of Commons on February 18, 1997.

Tuition fee and education tax credits

(2) That the provisions of the Act relating to the tuition fee and education tax credits be modified to

(a) include, in computing the expenses eligible for the tuition fee tax credit of a full-time student or a part-time student for the 1997 or a subsequent taxation year, ancillary fees (other than student association fees) paid to an educational institution, where the fees are

- (i) in respect of courses at the post-secondary school level, and
- (ii) required by the institution to be paid by all its full-time students or part-time students, respectively,

(b) allow the unused portion of a student's tuition fee tax credit and education tax credit for 1997 or a subsequent taxation year to be claimed (to the extent that it is not transferred in the year to a spouse or supporting individual) by the student in a subsequent taxation year, and

(c) increase the monthly amount on which the education tax credit is calculated from \$100 (as proposed in the 1996 Budget) to

- (i) \$150 for the 1997 taxation year, and
- (ii) \$200 for the 1998 and subsequent taxation years.

Registered education savings plans (RESPs)

(3) That, for the 1997 and subsequent taxation years, the \$2,000 annual limit on contributions to RESPs be increased to \$4,000.

(4) That,

(a) at any particular time after 1997, in addition to being permitted to distribute educational assistance payments, an RESP be permitted to distribute any part of its accumulated income to or on behalf of a person resident in Canada, where

(i) the person is the RESP's subscriber, if the subscriber is alive at the particular time,

(ii) each beneficiary in respect of whom the subscriber has made contributions to the RESP

(A) has, before the particular time, attained 21 years of age and is not eligible to receive educational assistance payments at the particular time, or

(B) has died before the particular time, and

(iii) either

(A) the particular time is after the ninth year that follows the year in which the first contribution was made by the subscriber under the RESP in respect of one of those beneficiaries, or

(B) each of those beneficiaries has died before the particular time and was, or was related to, the subscriber (or was the nephew, niece, great nephew or great niece of the subscriber),

(b) the amount so distributed be included in computing the income of the person, and

(c) the RESP be required to be terminated before March of the year following the year in which the distribution is made.

(5) That, where in the 1998 or a subsequent taxation year an RESP distributes to or on behalf of its subscriber any part of the RESP's accumulated income (otherwise than by way of an educational assistance payment), an additional tax be payable by the subscriber equal to the amount determined by the formula:

$$20\% \times (A - B)$$

where

A is the total of all such distributions made in the year from RESPs, and

B is the lesser of

(a) the total amounts deducted under subsections 146(5) and (5.1) of the Act in computing the subscriber's income for the year, and

(b) the amount by which \$40,000 exceeds the total of all amounts each of which is the lesser of the amount determined for A for a preceding taxation year and the amount determined under subparagraph (a) of this description for the preceding year.

(6) That, where at any time after 1997 an RESP distributes any part of its accumulated income (otherwise than by way of an educational assistance payment) and its subscriber had died before that time, an additional tax be payable by the recipient equal to 20 per cent of the amount of the distribution.

(7) That regulations be authorized to require the withholding by RESPs from their distributions made after 1997, where the withholding is on account of recipients' taxes payable under the Act.

(8) That, where after 1996 an individual under 21 years of age replaces the brother or sister of the individual as a beneficiary under an RESP, none of the contributions made to the RESP in respect of the brother or sister be taken into account in determining the amount of overcontributions to RESPs that have been made in respect of the individual.

(9) That, in order to accommodate distance education programs (such as correspondence courses) after 1996 for the purposes of the RESP rules, enrolment in a qualifying educational program as a full-time student at a post-secondary institution be considered full-time attendance at the institution.

(10) That the provisions of the Act relating to pre-1972 income of RESPs be repealed for the 1998 and subsequent taxation years.

Medical expense tax credit

(11) That, for the 1997 and subsequent taxation years,

(a) the list of expenses eligible for the medical expense tax credit be expanded to include

- (i) the lesser of 50 per cent of the cost of an air conditioner prescribed by a medical practitioner as being necessary to assist an individual in coping with the individual's severe chronic ailment, disease or disorder, and \$1,000,
- (ii) the lesser of 20 per cent of the cost of a van that, at the time of its acquisition or within six months after its acquisition, is adapted for the transportation of an individual requiring the use of a wheelchair, and \$5,000,
- (iii) reasonable expenses relating to alterations to the driveway of an individual's principal place of residence where the individual has a severe and prolonged mobility impairment and the alterations are made to facilitate the individual's access to a bus,
- (iv) reasonable expenses incurred in respect of an individual who lacks normal physical development or has a severe and prolonged mobility impairment to move to housing that is more accessible by the individual or in which the individual is more mobile or functional, to a maximum of \$2,000, and
- (v) sign language interpreter fees paid to a person who is in the business of providing such services, and

(b) the maximum amount of remuneration for part-time attendant care eligible for the medical expense tax credit be increased to \$10,000 from \$5,000 (and to \$20,000 from \$10,000 where the individual died in the year).

Refundable medical expense supplement

(12) That, for the 1997 and subsequent taxation years, eligible individuals be entitled to a refundable tax credit for the year equal to the amount by which

- (a) the lesser of
 - (i) \$500, and
 - (ii) 25 per cent of the allowable portion of medical expenses included in computing the individual's medical expense tax credit for the year

exceeds

(b) 5 per cent of the amount by which

- (i) the individual's adjusted income for the year exceeds
 - (ii) \$16,069

and, for this purpose,

- (c) "eligible individual" means an individual (other than a trust)
 - (i) who is resident in Canada throughout the year,
 - (ii) who is not, at the end of the year, a qualified dependant for the purpose of the Child Tax Benefit, and
 - (iii) whose total office, employment and business income for the year (without including amounts received in the year under a wage-loss replacement plan) is at least \$2,500, and
- (d) "adjusted income" of an eligible individual for a year means the total of the income of that individual and the income of the person who is, at the end of the year, that individual's cohabiting spouse.

Disability tax credit

(13) That, after February 18, 1997, a person authorized to practice as an audiologist be allowed to certify the existence of a severe and prolonged hearing impairment for the purpose of the disability tax credit.

Attendant care expenses

(14) That, for the 1997 and subsequent taxation years, the \$5,000 annual limit on the deductibility of attendant care expenses in computing a taxpayer's income be eliminated.

Preferred beneficiary election

(15) That a beneficiary under a trust not be excluded as a "preferred beneficiary" under the trust for any trust taxation year that ends after 1996 because the beneficiary does not claim a disability tax credit where another person is entitled to claim a dependant tax credit under paragraph (d) of the description of variable B in the formula used in subsection 118(1) of the Act in respect of the beneficiary.

CPP/QPP lump sum payments

(16) That the provisions of the Act under which an individual (other than a trust) may elect to

(a) exclude from the individual's income for a taxation year the portion of disability benefits received in the year under the Canada Pension Plan or the Quebec Pension Plan that relates to an earlier taxation year, and

(b) increase the individual's tax payable for the year by the additional tax that would have been payable by the individual for the earlier year if that portion had been included in computing the individual's income for the earlier year

apply to all benefits (rather than only to disability benefits) received after 1995 under those plans by such an individual.

Pension adjustment reversal

(17) That, for individuals terminating participation under a deferred profit sharing plan or a provision of a registered pension plan after 1996, measures relating to pension adjustment reversals be introduced for the 1998 and subsequent taxation years in accordance with the proposals described in the Budget Papers tabled by the Minister of Finance in the House of Commons on February 18, 1997.

Charitable donations

(18) That the provisions of the Act relating to charitable donations be modified to reduce to 37 1/2 per cent from 75 per cent the income inclusion rate of capital gains from gifts (other than gifts made to private foundations) made after February 18, 1997 and before 2002 of securities listed on prescribed stock exchanges.

(19) That, for taxation years commencing after 1996, the annual income limitation for charitable donations be changed from

(a) 50 per cent of the donor's income for the year, with respect to the donor's charitable gifts, and

(b) 100 per cent of the donor's income for the year, with respect to the donor's Crown gifts

to 75 per cent of the donor's income for the year with respect to all such gifts and by increasing that limitation by an amount equal to 25 per cent of

(c) the lesser of

- (i) the amount of recapture of capital cost allowance included in the donor's income for the year in respect of a prescribed class of depreciable property that included a property that was the subject of such a gift in the year, and
- (ii) for each such gift made in the year of property that was included in the class, the lesser of its capital cost and its fair market value, and

(d) the amount of taxable capital gains included in the donor's taxable income for the year from such gifts made in the year.

(20) That, for the purposes of determining the fair market value of a gift made after February 27, 1995 of a servitude, covenant or easement included in the total ecological gifts of a taxpayer, that value be considered to be the greater of the fair market value otherwise determined and the amount by which the fair market value of the land to which the gift relates is decreased as a result of the gift.

(21) That,

(a) where, at any time after February 18, 1997, a charity acquires

- (i) a debt obligation (other than a debt obligation listed on a prescribed stock exchange) of a person or partnership that does not deal at arm's length with the charity, or
- (ii) a share (other than a share listed on a prescribed stock exchange) of the capital stock of a corporation that does not deal at arm's length with the charity, or

(b) where

- (i) at any time a gift is made to a charity,
- (ii) an amount is deducted, in respect of the gift, in computing the donor's taxable income or tax payable under Part I of the Act for any taxation year, and
- (iii) within five years after the day of the gift,

(A) the charity holds a debt obligation of the donor or a person or partnership that does not deal at arm's length with the donor (other than a debt obligation listed on a prescribed stock exchange),

(B) the charity owns a share (other than a share listed on a prescribed stock exchange) of the capital stock of the donor or a corporation that does not deal at arm's length with the donor, or

(C) the donor or a person or partnership that does not deal at arm's length with the donor uses property of the charity (other than the use by a financial institution of an amount held on deposit),

a tax equal to 50% of

(c) where subparagraph (a) applies, the amount of the debt obligation or of the fair market value, at that time, of the share, and

(d) where subparagraph (b) applies, the lesser of

(i) the amount of the gift, and

(ii) the amount of the debt obligation or of the fair market value of the share or property

be payable by the charity and, where subparagraph (b) applies, the donor and the person, partnership or corporation referred to in subparagraph (b) be jointly and severally liable with the charity to pay that tax, except that subparagraph (b) does not apply where the gift referred to in that subparagraph was made before February 19, 1997 and, before that day,

(e) the charity held the debt obligation or the share referred to in that subparagraph, or

(f) the donor used the property of the charity referred to in that subparagraph.

(22) That, after Royal Assent to any measure giving effect to this paragraph, the Minister of National Revenue be authorized to make available to the public the following information relating to a registered charity:

(a) the charity's governing documents, including its statement of purpose,

(b) any information required to be provided by the charity upon applying for registration,

(c) the names of the charity's directors,

(d) the notification of registration including any conditions or warnings, and

(e) where the registration of the charity has been revoked, a copy of any letter sent by or on behalf of the Minister of National Revenue to the charity indicating the grounds for the revocation.

Investment tax credits

(23) That, in order for a cost incurred or an expenditure made to qualify for the investment tax credit, for claims made after February 18, 1997, a taxpayer be required to identify the cost or the expenditure as qualifying for the investment tax credit on a prescribed form filed with the Minister of National Revenue within twelve months of the taxpayer's filing-due date for the taxation year in which the investment tax credit in respect of the cost or the expense first arises, except that any such form may be filed by the later of the date otherwise required and May 31, 1997.

Environmental trusts

(24) That the rules governing mining reclamation trusts be extended to qualifying environmental trusts after February 18, 1997 in connection with the reclamation of property which is primarily used or had been primarily used for

- (a) the disposal of waste, or
- (b) the extraction of clay, peat, sand or shale or dimension stone, gravel or other aggregates.

Labour-sponsored venture capital corporations (LSVCCs)

(25) That, for eligible investments made by a federally-registered LSVCC after February 18, 1997,

- (a) the maximum total investment in an eligible business entity and all corporations related to it be increased to \$15 million from \$10 million,
- (b) the \$50 million asset limit in respect of an eligible business entity be applied immediately before, rather than immediately after, the LSVCC investment is made, and

(c) for the purpose of the 500 employee limit, the number of employees be calculated as the number of employees who normally work at least 20 hours per week plus 1/2 of the number of other employees.

(26) That, in determining the amount of tax payable under subsection 204.82(2) of the Act by a federally-registered LSVCC, the cost to the LSVCC of an eligible investment be considered to be 1.5 times the actual cost of the investment, provided

(a) the investment was made after February 18, 1997, and

(b) immediately before the investment was made, the carrying value of the total assets of the entity that issued the investment and all corporations related to it (determined in accordance with generally accepted accounting principles on a consolidated or combined basis, where applicable) did not exceed \$10 million.

(27) That, in determining the amount of tax payable under subsection 204.82(2) of the Act by a federally-registered LSVCC for each taxation year that ends after 1998, the excess that is referred to in that subsection at a particular time in the year be reduced by the amount by which

(a) 50 per cent of the total of

(i) the total cost to the LSVCC of eligible investments at the beginning of the year, and

(ii) the total cost to the LSVCC of eligible investments at the end of the year

exceeds

(b) the total cost to the LSVCC of eligible investments at the particular time.

(28) That, in determining the amount of tax payable under subsection 204.82(2) of the Act by a federally-registered LSVCC for each taxation year (referred to below as the "LSVCC's year") that ends after 1998,

(a) specified redemptions expected to occur after a particular taxation year that would otherwise reduce the LSVCC's shareholders' equity at the end of the particular year (or, where the LSVCC's year ends in 1999, 2000, 2001 or 2002, 20 per cent, 40 per cent, 60 per cent or 80 per cent, respectively, of the amounts of those expected redemptions) not reduce that shareholders' equity, and

(b) a specified redemption be

(i) any redemption that occurs within 60 days after the particular year where

(A) tax under Part XII.5 of the Act would have become payable as a consequence of the redemption if the redemption had occurred before the end of the particular year, and

(B) tax under Part XII.5 of the Act does not become payable as a consequence of the redemption, and

(ii) any other redemption that does not occur within 60 days after the particular year.

(29) That, where an amount becomes payable to the government of a province after February 18, 1997 by an LSVCC (other than a federally-registered LSVCC) as a consequence of the failure to meet any provincial investment requirements or the revocation, deregistration, winding-up or dissolution of the LSVCC,

(a) except to the extent otherwise expressly provided, the LSVCC be liable for an equal amount under the Act, and

(b) the Minister of National Revenue be required to refund amounts paid under the Act by the LSVCC on account of the liability, to the extent that the corresponding amounts have been refunded by the government of the province.

(30) That, for the 1991 and subsequent taxation years, a mutual fund corporation (including an LSVCC) or a mutual fund trust not be treated as a trader or dealer in securities for the purpose of the election under subsection 39(4) of the Act with respect to dispositions of Canadian securities.

Part VI surtax

(31) That the 12 per cent surtax on financial institutions (other than life insurers) be extended to October 31, 1998, prorated for taxation years that end after October 1998.

Notice of Ways and Means Motion to Amend the *Excise Tax Act*

That it is expedient to amend the *Excise Tax Act* to provide among other things:

(1) That for the purposes of determining the tax imposed under subsection 23(1) or (4) of the Act in respect of fuel, the volume of the fuel be measured in accordance with

(a) the temperature compensated method, where that method is used by the manufacturer or producer of the fuel, or by the licensed wholesaler, for the purpose of establishing the amount of fuel delivered and charged to the purchaser, or by the importer of the fuel to establish the amount of fuel imported, or

(b) the uncompensated method, where that method is used by the manufacturer or producer of the fuel, or by the licensed wholesaler, for the purpose of establishing the amount of fuel delivered and charged to the purchaser, or by the importer of the fuel to establish the amount of fuel imported.

(2) That for the purposes of any enactment founded on paragraph (1),

(a) “fuel” be defined as gasoline, diesel fuel and aviation fuel;

(b) “temperature compensated method” be defined as the method involving the measurement of the volume of fuel in litres that are corrected to the reference temperature of 15 degrees Celsius in accordance with the requirements imposed by or under the *Weights and Measures Act*; and

(c) “uncompensated method” be defined as the method involving the measurement of the volume of fuel in litres that are not corrected to a reference temperature.

(3) That any enactment founded on paragraphs (1) and (2) be effective on and after February 19, 1997.

(4) That interest be imposed on any increase in the amount of excise tax payable on gasoline, diesel fuel and aviation fuel pursuant to any enactment founded on paragraphs (1) and (2) that is not remitted within the time within which it would have been required to have been remitted had that enactment been assented to February 19, 1997, calculated at the rate prescribed for purposes of the *Customs Act*, in the case of imported gasoline, diesel fuel and aviation fuel, and at the rate prescribed for purposes of the *Excise Tax Act*, in any other case.

Notice of Ways and Means Motion to Amend the *Customs Tariff*

That it is expedient to amend Schedule II to the *Customs Tariff* by adding, after code 2530, the code set out in the following schedule:

Table A6.2

Schedule

Code	Provision	Most-favoured-nation tariff	General preferential tariff
2531	Goods specifically designed to assist persons with disabilities in alleviating the effects of those disabilities, and articles and materials for use in such goods ...	Free	Free

